

WRITTEN 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

The Securities and Exchange Commission appreciates the opportunity to participate in these hearings on proposed amendments to the Foreign Corrupt Practices Act of 1977. The Commission recognizes that the Foreign Corrupt Practices Act has spawned unintended difficulties for American commerce abroad and uncertainties concerning compliance with the accounting provisions. Senator Chafee's bill, S. 708, effectively addresses these problems. The Commission does not object to the bill's proposed consolidation in the Department of Justice of authority to enforce the foreign bribery prohibitions. The Commission will offer limited amendments to other S. 708 provisions, which would, among other things:

- (a) afford corporate management greater latitude in determining the cost-effectiveness of controls;
- (b) provide corporations greater protection against liability for violations without senior management's knowledge or involvement;
- (c) revise certain terms to reduce ambiguities and conform them more closely to accounting and securities law terminology; and
- (d) protect the confidentiality of certain business records.

The changes which the Commission recommends to accomplish the foregoing goals fall within three principal categories. */

First, the Commission proposes an amendment to Section 24 of the Securities Exchange Act in order to protect the confidentiality of certain business records. This provision would solve problems which both business and the Commission have encountered as a result, in part, of the extensive number of sensitive corporate documents which came into the Commission's possession in the course of its inquiries concerning questionable payments.

Second, the Commission recommends four measures to reduce or eliminate uncertainty concerning the scope of the accounting provisions and the burdens imposed on the business community. The effects of these four amendments to S. 708 are briefly described as follows:

- (a) In order to afford greater management latitude in determining the cost-effectiveness of internal controls, it is recommended that those responsible not be required to change or improve such controls unless they determine that the economic benefits will "significantly" exceed the costs.
- (b) Amplification of the term "accounting records" is suggested in order to reduce uncertainty concerning the scope of the accounting provisions.
- (c) In order to clarify parent companies' exposure for non-compliance by subsidiaries, the

*/ All of the Commission's recommendations, including minor, technical revisions, are set forth in the Appendix to this statement.

Commission proposes a more precise definition of control.

- (d) The Commission also proposes that corporations not be liable for accounting provision violations which were without senior management's knowledge or involvement.

Third, the Commission recommends that the definition of two S. 708 terms be revised to conform more closely to existing accounting and securities law terminology.

- (a) The Commission recommends that the S. 708 "scienter" standard be expanded from "knowingly" to "knowingly or recklessly" in order to conform the bill to the judicial construction of scienter in other provisions of the federal securities laws. */
- (b) It is also proposed that the definition of "materiality" should be revised to specify that the threshold standard for accuracy of corporate books and records and internal controls be that which a prudent man would require in the management of his own affairs.

S. 708 defines materiality as "used in the same sense as in generally accepted accounting principles when those principles are applied to the preparation and presentation of financial statements of the issuer." This standard is not defined in accounting literature. The guidance afforded under generally accepted auditing standards includes qualitative as well as quantitative judgments. If S. 708 intends only to require record-keeping accuracy and controls which affect numbers appearing in

*/ Healey v. Catalyst Recovery of Pennsylvania, Inc., 616 F.2d 641, 649-651 (3d Cir. 1980); Wright v. Heizer Corp., 560 F.2d 236, 251-252 (7th Cir. 1977); cert. denied, 434 U.S. 1066 (1978); Pegasus Fund, Inc. v. Laranetta, 617 F.2d 1335, 1340-1341 (9th Cir. 1980).

published financial statements (which are commonly rounded off in millions of dollars), the Commission would not oppose repeal of the FCPA accounting provisions.

Since inception of the federal securities laws in the 1930s, the Commission has been charged with the responsibility to sanction issuers which publish inaccurate financial statements. */ If the FCPA accounting provisions were repealed, the Commission would retain at least the equivalent authority as under the above interpretation of the S. 708 definition of materiality.

However, the Commission believes the "prudent man" test eliminates issuers' concerns over de minimus inaccuracies and sets an appropriate minimum standard for publicly owned corporations.

I. Background

As the unanimous enactment of the Foreign Corrupt Practices Act in 1977 demonstrated, Congress was seriously concerned over the 450 instances of questionable corporate payments, both at home and abroad, disclosed pursuant to the Commission's traditional reporting requirements. However, new legislation often proves to contain unanticipated ambiguities and is subject to differing constructions. The Commission has recognized that

*/ Section 13(a) of the Securities Exchange Act of 1934.

the Foreign Corrupt Practices Act has generated a substantial degree of consternation among businessmen of utmost good faith. */ For that reason, the Commission has attempted to afford guidance concerning its interpretation of the accounting provisions, **/ to coordinate our activities with the Justice Department's efforts to afford guidance concerning the bribery prohibitions, ***/ and to apply the Act only to clear-cut violations.

S. 708 would amend the FCPA in two important respects. First, it would repeal Section 103 (now embodied in Section 30A of the Exchange Act), which prohibits publicly-held companies from bribing foreign officials, and recreate that prohibition, with certain changes, in the statutes administered by the Department of Justice.

Second, S. 708 would clarify the accounting provisions of the Foreign Corrupt Practices Act (now embodied in Section 13(b)(2) of the Exchange Act). Most notably, S. 708 would:

- introduce a materiality standard threshold in both the recordkeeping and internal controls requirements;

*/ Securities Exchange Act Release 17500, 21 SEC Docket 1466, 46 F.R. 11544 (Jan. 29, 1981) (hereinafter Commission Policy Statement).

**/ Id. See also Securities Exchange Act Release No. 15570 (Feb. 15, 1979), 44 F.R. ¶10964; Securities Exchange Act Release No. 15772 (April 30, 1979), 44 F.R. ¶26702 (May 4, 1979); Securities Exchange Act Release No. 16877 (June 6, 1980) 45 F.R. 10134 (June 13, 1980).

***/ Securities Exchange Act Release No. 17099 (August 28, 1980), 45 F.R. 59001.

- define the phrase "reasonable assurances" in the internal control requirement to make clear that the term encompasses a weighing of the relative costs and benefits of control measures;
- limit the business documents to which the accounting provisions apply to "books, accounting records, and accounts;"
- eliminate liability under the accounting provisions in the absence of scienter; and
- require corporations only to make good faith efforts to cause compliance with the accounting provisions by companies in which they have only a minority interest.

II. Bribery Prohibition

The Foreign Corrupt Practices Act charges the Commission with responsibility for civil enforcement of the prohibition against the bribery of foreign government officials by corporations registered with the Commission. S. 708 would transfer this responsibility to the Justice Department. The Commission does not object to this proposal. */

The Commission's traditional mandate with respect to issuers of securities is investor protection through full disclosure. The bribery prohibition has no direct nexus to that mandate. Accordingly, during the legislative debates preceding enactment of the Foreign Corrupt Practices Act, the Commission made clear

*/ The Commission expresses no view concerning the changes which S. 708 would make in the substance of the bribery prohibition, since the Commission would have no responsibility for its administration.

that the prohibition of foreign bribery raised important issues of national policy unrelated to the objectives of the federal securities laws. For these reasons, then-SEC Chairman Hills recommended to the Senate Banking Committee that, if Congress chose to outlaw such transactions, it not do so under the federal securities laws. */ However, Congress decided to assign responsibility for civil enforcement of these prohibitions to both the Commission and the Justice Department, and criminal enforcement to the Justice Department.

Section 30A has not been an important part of the Commission's enforcement authority. In part, that is because of the difficulties of investigating transactions outside of the U.S. It is also reasonable to assume that bribery of foreign officials by issuers is less prevalent than it used to be because of the Foreign Corrupt Practices Act. The Commission has maintained actions dealing with improper foreign payments under other provisions of the Securities Exchange Act.

*/ Testimony of Roderick M. Hills, Chairman, Securities and Exchange Commission, Before the Senate Committee on Banking, Housing, and Urban Affairs, p. 9 (March 16, 1977).

It has been suggested that consolidation of civil enforcement of the foreign bribery prohibitions within the Justice Department would have certain advantages; that, as a cabinet department, the Justice Department is in a better position than the Commission to evaluate -- in cooperation with the Special Trade Representative and the Commerce and State Departments -- the broad impact of the bribery prohibitions on U.S. foreign policy and trade and to initiate appropriate international agreements to curb such practices; and that it would also consolidate within a single agency enforcement of the sanctions against foreign bribery regardless of whether the violator is a Commission registrant or a private company, and it would facilitate administrative guidance to the business community.

The Commission's primary mission is disclosure, not substantive regulation of day-to-day commercial transactions. Despite repeal of Section 30A, 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 under the federal securities laws. So long as the Commission has that authority, its principal role under the securities laws can be fulfilled. For these reasons, the Commission would not oppose this provision of S. 708.

III. Accounting Provisions

The accounting provisions of the FCPA require publicly-held companies to satisfy two mandates:

First, such companies must "make and keep books, records and accounts, which, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the issuer." */

Second, issuers must maintain a system of internal accounting controls which provides "reasonable assurances" that four specific financial reporting and accountability goals are met. **/

As the legislative history of the Foreign Corrupt Practices Act makes clear, the accounting provisions were enacted in part to facilitate the disclosure provisions of the federal

*/ Section 13(b)(2)(A) of the Securities Exchange Act of 1934.

**/ Id., Section 13(b)(2)(B). These objectives are that:

- (i) transactions are executed in accordance with management's general or specific authorization;
- (ii) transactions are recorded as necessary (a) to permit preparation of financial statements in conformity with generally accepted accounting principles or any other criteria applicable to such statements, and (b) to maintain accountability for assets;
- (iii) access to assets is permitted only in accordance with management's general or specific authorization; and
- (iv) the recorded accountability for assets is compared with the existing assets at reasonable intervals and appropriate action is taken with respect to any differences.

securities laws and in part to provide for greater accountability of corporate assets. They were not intended exclusively to curb foreign bribery. Rather, the large number of serious questionable payments which led to enactment of the FCPA were viewed as symptomatic of a threat to the disclosure system which the Commission administers. For that reason, the Commission believes that the substance of the accounting provisions should be retained, but appropriately refined to remove ambiguities and unnecessary burdens.

S. 708 would make it clear that intentional falsifications of corporate records and significant failures in control remain a matter of Congressional concern, but that corporations would not be required to adopt controls which are not cost-effective or to guaranty absolute accuracy in recordkeeping. The Commission concurs in these objectives.

A. Additions to S. 708 to Provide Greater Certainty

The Commission has identified four accounting areas in which S. 708 could afford even greater management latitude and specificity.

1. Cost-Effectiveness of Internal Controls

Some believe the FCPA requires expensive internal controls which are unnecessary for any business purpose. In its January, 1981, policy statement presented by then-Chairman Harold M. Williams, the Commission sought to allay such concerns:

"[C]onsiderable deference properly should be afforded to the company's reasonable business judgments in this

area * * *. Importantly, the selection and implementation of particular control procedures, so long as they are reasonable under the circumstances, remain management prerogatives and responsibilities." */

S. 708 deals with this problem by providing that the FCPA term "reasonable assurances" means that --

"degree of assurance as 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." **/

In evaluating controls, the Commission believes a reasonable assessment of costs and benefits should be determinative -- not merely one factor to be considered as S. 708 proposes. Cost-benefit analysis is inherent in the accounting literature from which the internal control provision was drawn. Section 320.32 of Statement on Auditing Standards No. 1 provides that "[t]he concept of reasonable assurance recognizes that the cost of internal control should not exceed the benefits to be derived." ***/

*/ Commission Policy Statement, 21 SEC Docket at 1470 (emphasis in original). The Commission had previously taken the same position in Securities Exchange Act Release No. 16877 (June 6, 1980), 20 SEC Docket at 322, in which the Commission announced the withdrawal of a rule proposal which, if adopted, would have required inclusion of a statement of management on internal accounting control in annual reports. In this release, the Commission recognized that decisions on reasonable assurance necessarily depend on estimates and the informed judgment of management.

**/ Proposed Section 13(b)(6), Section 6(a) of S. 708.

***/ The internal control requirement now found in Section 13(b)(2)(B) of the Securities Exchange Act is virtually identical to that found in Section 320 of SAS No. 1.

SAS No. 1 provides further that "the benefits [of internal control] consist of reductions in the risks of failing to achieve the objectives implicit in the definition of accounting control."

In order to make clear that the accounting provisions only require cost-effective controls, the Commission recommends that proposed Section 13(b)(6) delete the definition of "reasonable assurances." In lieu thereof, a sentence should be added to the internal control requirement itself which would provide that only controls which management believes will provide benefits "significantly" greater than their costs need be instituted. The specific language suggested is:

"Nothing herein shall require any issuer to take any action with respect to a system of internal controls, unless those responsible, acting as would prudent men in the management of their own property, determine that the economic benefits to be derived from such change or improvement will significantly exceed the costs to be incurred."

2. Scope of "Accounting Records"

Another concern is that the term "records" in the FCPA encompasses business documents unrelated to the accounting and control

*/ Section 3(a)(37) of the Securities Exchange Act defines the term "records" for purposes of that Act. This definition provides:

"The term 'records' means accounts, correspondence memorandums, tapes, discs, papers, books, and other documents or transcribed information of any type, whether expressed in ordinary or machine language."

(footnote cont'd)

"books, accounting records, and accounts" of the issuer be maintained in reasonable detail. */

The Commission agrees that this change helps to make clear that the Act only applies to certain records related to the financial disclosure and asset accountability systems. Since the term "accounting records" is undefined and subject to interpretation, however, the Commission believes it would be helpful if the legislative history indicated the documents the term is intended to reach. The Commission has taken the position that the accounting provisions should apply only to "records which are * * * related to internal or external audits or to the four internal control objectives set forth in the Act * * *." **/ More specifically, Congress may wish to provide that such records are those "created in the processing of corporate transactions, including dispositions of assets, liabilities, and equities, and in the handling of corporate assets." Such a definition, which is

(footnote cont'd)

In its recent policy statement, the Commission stated that it would construe the term "records" in the accounting provisions more narrowly, notwithstanding the terms of Section 3(a)(37). See Commission Policy Statement, 21 SEC Docket at 1470.

*/ Section 4(a) of S. 708.

**/ Commission Policy Statement, 21 SEC Docket at 1470. These objectives are set forth in a footnote on p. 9, supra.

narrower than Section 3(a)(37) of the Exchange Act, accords with the objectives of the accounting provisions as S. 708 would revise them.

3. Subsidiary Liability

A further concern under the FCPA relates to a parent company's liability for subsidiary recordkeeping and control violations. To clarify this area, S. 708 would provide that an issuer is liable if it holds 50 percent or more of the equity capital of a domestic or foreign firm, and that, if it holds less, it need only proceed "in good faith to use its influence" to cause material transactions and dispositions of assets in the subsidiary to be recorded or controlled consistent with the purposes of the accounting provisions. */ An issuer which meets this standard is conclusively presumed to have complied with the accounting provisions.

Although, in its recent policy statement, the Commission adopted a somewhat different standard, **/ the Commission concurs in the thrust of the S. 708 proposal. Both the policy statement

*/ Proposed Section 13(b)(5), Section 4(b) of S. 708. Presumably, the intent of this proposal is that, with respect to majority owned subsidiaries, the parent is equally as responsible for the subsidiary's records and controls as it is for its own.

**/ In the context of the current accounting provisions, the Commission's position is that, where an issuer owns between 20 and 50 percent of a subsidiary, a rebuttable presumption of control should be applied. Where the parent owns less than 20 percent, a rebuttable presumption of noncontrol arises. Commission Policy Statement, 21 SEC Docket at 1471.

and S. 708 would impose responsibility on an issuer which holds more than a 50 percent interest in a subsidiary. The bill defines such 50 percent interest in terms of "equity capital ownership." In some instances, however, equity capital may consist of non-voting preferred stock, or a class of common stock with disproportionate voting rights. Therefore, the Commission proposes that such 50 percent interest be defined in terms of "voting power" over the subsidiary, which would be determined by the percentage of the total votes which the parent company would be entitled to cast in an election of directors.

4. Issuer Liability

An additional concern of the business community is that, under the FCPA, an issuer could be held liable for recordkeeping violations or control circumventions committed by low-level corporate employees without the knowledge or sanction of corporate management. The Commission's recent policy statement made clear that it is inappropriate to hold the corporation itself liable for recordkeeping or internal controls violations by low or middle level employees, without any involvement by senior officials:

"With respect to issuer liability for recordkeeping violations, we will look to the adequacy of the internal control system of the issuer, the involvement of top management in the violation, and the corrective actions taken once the violation was uncovered. If a violation was committed by a low level employee, without the knowledge of top management, with an adequate system of internal control,

and with appropriate corrective action taken by the issuer, we do not believe that any action against the company would be called for." */

S. 708 does not address this issue. If enacted, issuers would still have grounds for concern that, under general agency law principles, record falsification by an employee could be attributed to the issuer, even though the issuer's management had taken reasonable steps to prevent, and was unaware of, the employee's misconduct.

The attribution of employee knowledge to the employer corporation is one means of holding an entity liable for violations of the law, since the "knowledge" of an entity is simply the aggregate of the facts known to its agents. **/ In other securities law contexts, this type of derivative issuer liability is appropriate. ***/ But in the special context of the FCPA accounting provisions as S. 708 would revise them, the Commission

*/ Commission Policy Statement, 21 SEC Docket at 1470.

**/ See United States v. A & P Trucking Co., 358 U.S. 121 (1958). In other instances, however, statutory language or judicial construction may hold an issuer liable without regard to such attribution. See, e.g., Section 11 of the Securities Act of 1933.

***/ See, e.g., Marbury Management, Inc. v. Kohn, 629 F.2d 705 (2d Cir.), cert. denied, 46 U.S.L.W. 3405 (Dec. 2, 1980); Securities and Exchange Commission v. Management Dynamics, Inc., 515 F.2d 801, 812-813 (2d Cir. 1975); Paul F. Newton & Co. v. Texas Commerce Bank, [1980 Transfer Binder] CCH Fed. Sec. L. Rep. ¶97,702 (5th Cir. 1980).

does not believe that automatic imputation of knowledge to the issuer is warranted. Therefore, the Commission recommends that S. 708 make clear the circumstances under which the issuer may be held responsible for an employee's failure to comply. The Commission believes that issuer responsibility in that context should result only if:

- (a) an officer or director of the issuer knew of (or recklessly disregarded) the violation; or
- (b) if the issuer:
 - (i) lacked a cost-effective internal control system; and
 - (ii) failed to take appropriate corrective or remedial action when the violation came to the attention of an officer or director. */

To implement these principles, the Commission therefore recommends that the following be added to proposed Section 13(b)(4):

An issuer may not be held liable for any failure to comply with the requirements of Section 13(b)(2) unless an officer or director knew, or acted in reckless disregard of whether, the conduct was occurring, or if the issuer cannot establish that it took appropriate corrective or remedial action upon discovery by an officer or director of the prohibited conduct. For purposes of this paragraph, the term "officer" shall mean the president, secretary, comptroller, treasurer, any vice president in charge of a principal business unit, division or function (such as sales, administration or marketing), and any other person who performs similar policymaking

*/ Commission Policy Statement, 21 SEC Docket at 1471.

functions. For purposes of this paragraph, directors and officers of a company with respect to which the issuer holds more than 50 per centum of the voting power are deemed directors and officers of the issuer. Nothing in this paragraph, however, shall affect the issuer's liability under any other provision of this title.

B. Amendments to Conform S. 708 to Established Accounting and Securities Law Concepts

S. 708 limits the accounting provisions to "material" errors and control weaknesses and adds a "scienter" requirement as conditions to liability for violations. The Commission supports the concepts underlying these changes, but recommends revisions of the definitions.

1. Threshold Standard

Some have hypothesized that the recordkeeping and internal control requirements could be construed as requiring absolute accuracy of de minimus data. In its recent policy statement, the Commission made clear that it would not interpret the existing recordkeeping and internal control requirements in such an extreme fashion. */ However, the Commission recognizes that

*/ Commission Policy Statement, 21 SEC Docket at 1469-70.

a matter of this gravity is better resolved by legislative amendment than by administrative interpretation.

The Commission, therefore, agrees that the establishment of a threshold, through a definition of the term "material," is appropriate to avoid confusion with respect to the scope of the accounting provisions of the FCPA. In defining the term "material" for this purpose, it is, however, necessary to determine according to whose needs materiality should be measured. There are three candidates: material to (1) shareholders, (2) accountants, or (3) businessmen who run companies. While each of these three types of materiality are, in some respects, similar, there are important distinctions between them.

The federal securities laws traditionally have focused on materiality to shareholders */ -- the information a reasonable investor would consider important "in deciding how to vote, or whether to buy, sell or hold securities." **/ The accounting

*/ In TSC Industries, Inc. v. Northway, 426 U.S. 438, 449 (1976), the Supreme Court stated that the materiality standard requires:

"a showing of a substantial likelihood that, under all the circumstances, the omitted fact would have assumed actual significance in the deliberations of the reasonable shareholder. Put another way, there must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available."

**/ Id.

provisions, on the other hand, are directed more broadly to management's conduct, i.e., the obligation to make and keep books and records */ and devise and maintain a system of internal accounting controls. **/ Thus, the substance of these provisions is not exclusively concerned with disclosure to investors, but also addresses other facets of management's responsibilities, such as maintaining accountability for assets. Therefore, the Commission believes the materiality standard should address the responsibilities of prudent businessmen.

S. 708 defines materiality in terms of accounting principles. It would require that books and records be made and kept so as to be accurate "in all material respects" ***/ and that internal controls provide reasonable assurances that the statutory objectives are met "in all material respects." ****/ The term "material" would be "used in the same sense as in generally accepted accounting principles when those principles are applied to the preparation and presentation of financial statements of the issuer." *****/

*/ Section 13(b)(2)(A) of the Securities Exchange Act of 1934.

**/ Id., Section 13(b)(2)(B).

***/ Proposed Section 13(b)(2)(A) of the Securities Exchange Act, Section 4(a) of S. 708.

****/ Id., proposed Section 13(b)(2)(B).

*****/ Proposed Section 13(b)(7), Section 6(a) of S. 708.

This definition has no clear reference in authoritative accounting literature. Generally accepted accounting principles contain no definition of materiality. */ Accounting principles are the assumptions and conventions under which financial statements should be prepared. However, GAAP does not specify the size or "significance" of the transactions to which those principles apply. Thus, materiality in the context of generally accepted accounting principles is an undefined term. **/

*/ The Financial Accounting Standards Board did discuss materiality in its Statement of Financial Concepts No. 2, "Qualitative Characteristics of Accounting Information," issued in May, 1980, as part of its conceptual framework project. The statement defined materiality as:

"The magnitude of an omission or misstatement of accounting information that, in the light of surrounding circumstances, makes it probable that the judgment of a reasonable person relying on the information would have been changed or influenced by the omission or misstatement."

**/ The guidance concerning materiality afforded under generally accepted auditing standards (GAAS) includes qualitative as well as quantitative judgments. Section 509.16 of Statement on Auditing Standards No. 1 provides:

"In deciding whether the effects of a departure from generally accepted accounting principles are sufficiently material to require either a qualified or an adverse opinion, one factor to be considered is the dollar magnitude of the effects. However, materiality does not depend entirely on relative size: the concept involves qualitative as well as quantitative judgments. The significance of an item to a particular enterprise (e.g., inventories to a manufacturing company), the pervasiveness of the misstatement (footnote cont'd)

Moreover, by referring to GAAP and to the preparation of financial statements, Section 6(a) of S. 708 is susceptible to the interpretation that Congress intends only to require record-keeping accuracy and controls which affect numbers appearing in published financial statements. In the case of publicly-owned companies, such numbers are commonly rounded off in millions of dollars. The Commission pointed out in its policy statement:

"For a particular expenditure to be material in the context of a public corporation's financial statements -- and therefore in the context of the size of the company -- it would need to be, in many instances, in the millions of dollars. Such a threshold, of course, would not be a realistic standard. Procedures designed only to uncover deficiencies in amounts material for financial statement purposes would be useless for internal control purposes.

Systems which tolerate omissions or errors of many thousands or even millions of dollars would not represent, by any accepted standard, adequate records and controls. The off-book expenditures, slush funds, and questionable payments that alarmed the public and caused Congress to act, it should be remembered, were in most instances of far lesser magnitude than that which would constitute financial statement materiality." */

The application of such quantitative financial statement materiality to the accounting provisions would place many substantial falsifications relating to bribery, embezzlement,

(footnote cont'd)
(e.g., whether it affects the amounts and presentation of numerous financial statement items), and the impact of the misstatement on the financial statements taken as a whole are all factors to be considered in making a judgment regarding materiality."

*/ Commission Policy Statement, 21 SEC Docket at 1469.

misappropriation, and other misconduct outside the scope of the recordkeeping provision. This would be true even though such conduct was "material" under well-accepted case law construing that term for purposes of the securities laws generally. */

The Commission's rules implementing Section 13(a) of the Securities Exchange Act of 1934 have always required publicly-held corporations to file accurate financial statements with the Commission. If the S. 708 accounting provisions are to have substance, they must reach records and controls which are relevant to disclosures beyond the financial statements and to the objective of attaining a reasonable level of accountability for assets, even though not necessarily material to the financial statements. If that is not the intent of Congress, the Commission would not oppose repeal of the accounting provisions, since the Commission already has adequate statutory authority to sanction issuers which file inaccurate financial statements. **/

*/ See, e.g., United States v. Fields, 592 F.2d 638 (2d Cir. 1978), cert. denied, 442 U.S. 917 (1979); Maldonado v. Flynn, 597 F.2d 789 (2d cir. 1979).

**/ See Section 13(a) and 17 CFR §240.13a et seq.

Moreover, other provisions of the existing securities laws require disclosure of questionable payments in appropriate cases. In this regard, the Commission's "Report on Questionable and Illegal Corporate Payments and Practices" to the Senate Committee on Banking, Housing and Urban Affairs, 95th Cong., 1st Sess. (1976) at 14-15 points out:

"[T]he Commission has been of the view 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."

For these reasons, the Commission believes that, if the accounting provisions are to have meaningful content, the appropriate focus in defining "materiality" is that of prudent businessmen in the conduct of their own affairs. The accounting provisions of the FCPA, as noted above, are concerned with the conduct expected of management in making basic determinations concerning corporate records and controls and, accordingly, the term "material" should establish the standard expected in that context. The Commission believes most businessmen are scrupulously honest. They want to see those who lie, cheat and steal exposed and prosecuted. They want to compete in a fair environment in which the rewards go to those who deserve them. They do not want the standards set so low that "it pays" to engage in self-dealing and intentional abuse of companies and their shareholders.

In order to implement this concept in the accounting provisions, the Commission recommends that Section 6(a) of the bill be revised to provide that --

"For the purposes of paragraphs (b)(2), (4), and (5) of this section, a matter is 'material' to the extent that a prudent man would be likely to consider the matter important in the management of his own property." */

*/ As presently drafted, S. 708 provides that the special materiality definition which Section 6(a) would create applies "for purposes of this section." The section in which the provision would be codified is Section 13 of the Securities Exchange Act. In addition to the accounting provisions, Section 13 contains a number of other (footnote cont'd)

This standard looks to whether a transaction or control is of the type that, if not remedied, exposes the issuer to a significant risk -- from a prudent man's standpoint -- either in terms of accurate financial reporting or maintaining a reasonable level of accountability for assets. It is consistent with the Commission's proposed revision to the definition of "reasonable assurances" */ and also parallels existing statutory provisions of the federal securities laws. **/ Since 1933, businessmen and securities professionals have worked under this standard without adverse effect on the capital-raising process.

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key components of the federal securities law, including Subsections 13(a) (periodic reporting), 13(d) (reports concerning the acquisition of securities), 13(e) (going private transactions), 13(f) (reports of institutional investment managers), and 13(g) (beneficial ownership reporting). While it is clear that the drafters of S. 708 do not intend their special definition of materiality to apply outside Paragraphs 13(b)(2), (4), and (5), the present language of the bill lends itself to misinterpretation. Accordingly, whether or not the other changes the Commission is recommending are adopted, it is vital that the introductory phrase of proposed Section 13(b)(7) be revised to read, "For purposes of paragraphs 13(b)(2), (4), and (5) of this section, * * *."

*/ See p. 12, supra.

**/ Section 11(c) of the Securities Act of 1933 provides:

"In determining* * *what constitutes reasonable investigation and reasonable ground for belief, the standard of reasonableness shall be that required of a prudent man in the management of his own property."

2. Scienter Standard

Concern has also been expressed that issuers may be liable under the accounting provisions for inadvertent mistakes in recordkeeping and control. The Commission agrees that such a construction is not intended, and has previously stated that inadvertant violations do not merit federal enforcement actions:

** * * [N]othing in the Congressional objectives of the accounting provisions requires that inadvertent recordkeeping inaccuracies be treated as violations of the Act's recordkeeping provision. The Act's principal purpose is to reach knowing or reckless misconduct. * * *

Neither its text and legislative history nor its purposes suggest that occasional, inadvertent errors were the kind of problem that Congress sought to remedy in passing the Act. No rational federal interest in punishing insignificant mistakes has been articulated." */

Section 4(b) of S. 708 seeks to address this issue by providing that:

"(4) A person shall be liable in any action or proceeding arising under paragraph (2) only for knowingly falsifying, or causing to be falsified, any book, accounting record, or account described therein, or for knowingly failing to maintain a system of internal accounting controls which is consistent with the purposes of paragraph (2), or for knowingly attempting to circumvent wrongfully the internal accounting controls established pursuant to such paragraph."

The Commission agrees with the foregoing concept, and recommends the following revisions, primarily in order to conform

*/ Commission Policy Statement, 14 SEC Docket at 1471.

to well established case-law construing scienter under Section 10(b) of the Securities Exchange Act:

-- The courts have interpreted the word "knowingly" to include reckless conduct. */ Conduct which totally disregards the accuracy of corporate records or the integrity of controls is as damaging as conduct calculated to falsify records or circumvent controls. To avoid litigation on this point, the Commission recommends that the phrase "knowingly or recklessly" be employed.

-- In view of the explicit inclusion of the "knowingly" standard, it is difficult to predict what additional requirement the courts would construe "wrongfully" to entail. It could be construed to require awareness that the activity was unlawful. This would be inconsistent with the established doctrine that knowledge of impropriety -- not knowledge of illegality -- is sufficient.

-- This provision should also cover knowing failures to make records as well as to correct falsifications.

For these reasons, the Commission recommends revising Section 4(b) of S. 708 to read as follows:

"(4) A person shall be liable in any action or proceeding arising under paragraph (2) only for knowingly or recklessly (A) falsifying, or causing to be falsified, any book, accounting record, or account described therein; (B) failing to make or keep a book, record, or account described therein; (C) failing to maintain a system of internal accounting controls which is consistent with the purposes of paragraph (2), or

*/ See, e.g. Healey v. Catalyst Recovery of Pennsylvania, Inc., 616 F.2d 641, 649-651 (5th Cir. 1980); Mansbach v. Prescott, Ball & Turben, 598 F.2d 1017, 1023-1025 (6th Cir. 1979); Wright v. Heizer Corp., 560 F.2d 236, 251-252 (7th Cir. 1977), cert. denied, 434 U.S. 1066 (1978).

(D) attempting to circumvent the internal accounting controls established pursuant to such paragraph.*

IV. Other Recommendations

The Commission's suggestions concerning other changes to S. 708 are set forth in the Appendix hereto. While these are largely technical, two significant proposals are described below.

A. Access to Business Records in the Commission's Possession

In the course of its inquiries concerning questionable foreign payments, the Commission came into possession of thousands of business documents and records describing the overseas activities of hundreds of American companies. There have been repeated efforts to force public disclosure of these records under the Freedom of Information Act, frequently over the vigorous objections of the companies which furnished this information to the Commission. */ Substantial Commission time and expense have gone

*/ Many lawsuits seeking access to these records under the Freedom of Information Act have been filed against the Commission and law enforcement agencies which reviewed these corporate records from the Commission. Of particular note is the litigation brought by Dow Jones Corporation, the owner of the Wall Street Journal, against the Commission, the Department of Justice, and the Department of State, seeking access to all records relating to questionable corporate payments and the Commission's voluntary disclosure program. Dow Jones, Inc. et al. v. SEC, et al., (No. 79-1238, D.D.C., filed March 4, 1977). These records relate to over 500 corporations, many of which are requesting confidential treatment for these records, (footnote cont'd)

into determining which of these records are exempt from disclosure under the FOIA and which are not. Similarly, corporations have incurred substantial legal fees and other costs in seeking to demonstrate to the Commission that it is justified in withholding particular documents from FOIA-requestors.

The Commission must carefully weigh competing interests in fulfilling its obligations to disclose records to the public under the FOIA. At the same time, the Commission has an obligation to preserve the legitimate confidentiality of the corporations and individuals who submit information to the Commission. It has been the Commission's experience that the FOIA is frequently utilized by competitors, litigants, and other adversaries to those who have submitted information to the Commission. Such requesters seek to use the Commission's investigatory files as a means of discovering sensitive information which may afford a business or other advantage over the submitter of information. While FOIA Exemption 4 permits the Commission to withhold trade secrets and certain other confidential business and financial information, the courts have construed that exemption rather narrowly. */

(footnote cont'd)

including a large number which are non-public and were provided to the Commission in confidence. And, some corporations have intervened in litigation to protect their interests directly.

*/. See generally, Board of Trade of the City of Chicago v. Commodity Futures Trading Commission, No. 78-1089, (D.C. Cir., May 13, 1980); National Parks and Conservation Association v. Morton, 498 F.2d 765 (D.C. Cir. 1974).

Moreover, in many cases, Commission investigation reveals no need to bring enforcement action against particular individuals or businesses who have come under inquiry. Unfortunately, however, the FOIA is unclear concerning whether closed investigatory records may be protected from disclosure, despite the fact that no actionable wrongdoing was discovered and public revelation of the fact of investigation may seriously injure and embarrass those involved. */ This latter problem has been particularly acute with respect to the Commission's foreign payments files.

Section 8 of S. 708 would go a long way towards alleviating these concerns by providing an exemption from the FOIA for "any document or material" submitted to any federal agency "in connection with any investigations conducted to enforce" the accounting or foreign payments provisions of the bill. The Commission fully supports this provision. At the same time, however, the Commission wishes to point out that the language employed may be unduly narrow to effectuate fully the apparent intention of the drafters. As drafted, the provision would not exempt material received by the Commission in the course of an investigation of sensitive or questionable payments unless a violation of the accounting provisions

*/ Of course, this concern would not apply to information which has become public knowledge in the course of judicial or administrative proceedings.

of the bill were alleged. Most Commission investigations in this area, as well as those into other corporate matters of equal sensitivity, often focus on allegations of violations of the antifraud or reporting provisions of the federal securities laws, and may or may not include also a specific accounting provision allegation. Accordingly, the Commission recommends that Section 24 of the Securities Exchange Act be amended to exempt from disclosure under the FOIA any materials obtained by the Commission pursuant to any such inquiry or investigation. In order to accomplish this objective, Section 24 should be revised by the addition of language which would provide that --

"any materials which are received by the Commission in any investigation or inquiry permitted by the federal securities laws as defined in Section 21(g), or the rules and regulations adopted thereunder, and which is provided pursuant to any compulsory process under this Act or which is provided voluntarily in place of such compulsory process shall be exempt from disclosure under Section 552 of title 5, United States Code."

Because this revision relates only to Section 24 of the Securities Exchange Act and the definition of records contained therein, it would not effect a change in the FOIA itself or in the information disclosure practices of any other federal agency. */

*/ The Commission has recently proposed a rule which would address some of the concerns addressed by this proposed amendment. See Securities Exchange Act Release No. 17582 (Feb. 27, 1981). While this rulemaking proceeding is under active consideration, we believe that the Congressional action would be an appropriate means of accomplishing the same goal and would be a desirable Congressional affirmation of the privacy rights of businesses which have come under Commission investigation but which have not been the subject of enforcement proceedings.

B. Exclusivity

Section 7 of S. 708 provides that Section 104 of the Act shall be the exclusive authority for civil or criminal proceedings regarding overseas bribery. The explanation accompanying S. 708 states, however, that Section 7 would "leave unchanged the possible applicability of the securities laws and other criminal statutes to overseas bribery including Section 102 of the [Act], disclosure requirements of the 1933 and 1934 Acts, and false statements provisions." */ The language of Section 7 could, however, be construed more broadly than the explanatory statement suggests was intended. Indeed, the phrase "exclusive authority" could be construed to mean that the federal securities laws are not to apply to transactions which are within the scope of amended Section 104. Accordingly, the Commission recommends that the continued applicability of the federal securities laws to conduct within the scope of revised Section 104 of the Act be made clear in the language of the statute itself. Language which would implement this suggestion is set forth in the Appendix.

*/ Cong. Rec. S.2151 (March 12, 1981).

APPENDIX

Set forth below are the changes necessary in the present version of S. 708 in order to implement the Commission's comments. Deletions are in [brackets]. Additions are underscored. (Explanations are single-spaced, and in parentheses.)

A BILL

To amend and clarify the Foreign Corrupt Practices Act of 1977.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That this Act may be cited as the "Business Accounting and Foreign Trade Simplification Act."

Findings and Conclusions

Section 2. (a) The Congress finds that --

- (1) (No changes)
- (2) The [unclear nature of the enforcement, and interpretation of the] Foreign Corrupt Practices Act of 1977 [by United States agencies] has caused unnecessary concern [confusion] among existing and potential exporters as to the scope of legitimate overseas business activities;
- (3) The accounting standards requirements of the Foreign Corrupt Practices Act of 1977, which apply to all publicly-held issuers of securities regardless of size, market, or the presence of international transactions, are unclear and excessive and [they] have caused costly and unnecessary paperwork burdens;

(4) (No change)

(5) (No change)

(b) The Congress concludes that --

(1) (No change)

(2) (No change)

(3) The accounting standards requirements of the Foreign Corrupt Practices Act of 1977 should be integrated with concepts of materiality [as they are understood and interpreted in the context of generally accepted accounting principles,] and accordingly, should take into consideration the size and operations of issuers of securities;

(4) (No change)

(5) (No change)

(Comment: These changes are designed to emphasize that the principal ambiguities and difficulties in the present Act are in the statutory language itself, and to conform the standard of materiality in accord with our comments at pp. 18-25 of the Written Statement).

Amendment of Short Title

Section 3. Section 101 of the Foreign Corrupt Practices Act of 1977 is amended to read as follows:

Short Title

Section 101. This title may be cited as the "Business Practices and Records Act."

Accounting Standards

Section 4. (a) Section 13(b)(2) of the Securities Exchange Act of 1934 is amended by striking out clauses (A) and (B) and inserting in lieu thereof the following:

"(A) make and keep books, accounting records, and accounts which reflect in reasonable detail the transactions of the issuer (including the disposition of assets) in all material respects so as (i) to permit preparation of financial statements in conformity with generally accepted accounting principles or other criteria applicable to such statements, and (ii) to maintain accountability for assets; and

"(B) devise and maintain a system of internal accounting controls sufficient to provide reasonable assurances that in all material respects --

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

Nothing herein shall require any issuer to take any action with respect to a system of internal controls unless those responsible, acting as would prudent men in the management of their own property, determine that the economic benefits to be derived from such change or improvement will significantly exceed the costs to be incurred."

(Comment: see pp. 10-12 of the Written Statement).

(b) Section 13(b) of the Securities Exchange Act of 1934 is amended by adding at the end thereof the following:

"(4) A person shall be liable in any action or proceeding arising under paragraph (2) only for knowingly or recklessly (A) falsifying, or causing to be falsified, any book, accounting record, or account described therein; (B) failing to make or keep a book, record, or account described therein; (C) [or for knowingly] failing to maintain a system

of internal accounting controls which is consistent with the purposes of paragraph (2), or (D) [for knowingly] attempting to circumvent [wrongfully] the internal accounting controls established pursuant to such paragraph. An issuer may not be held liable for any failure to comply with the requirements of Section 13(b)(2) unless an officer or director knew, or acted in reckless disregard of whether, the conduct was occurring, or if the issuer cannot establish that it took appropriate corrective or remedial action upon discovery by an officer or director of the prohibited conduct. For purposes of this paragraph, the term "officer" shall mean the president, secretary, controller, treasurer, any vice president in charge of a principal business unit, division or function (such as sales, administration or marketing), and any other person who performs similar policy-making functions. For purposes of this paragraph, directors and officers of a company with respect to which the issuer holds more than 50 per centum of the voting power are deemed directors and officers of the issuer. Nothing in this paragraph, however, shall affect the issuer's liability under any other provision of this title."

(Comment: see pp. 26-28 and 15-18 of the Written Statement).

"(5) Where an issuer holds 50 per centum or less of the voting power with respect to [equity capital of] a domestic or foreign firm, the provisions of paragraph (2) require only that the issuer proceed in good faith to use its influence, to the extent reasonable under the issuer's circumstances, including the relative degree of its ownership over the domestic or foreign firm and under the laws and practices governing the business operations of the country in which such firm is located, to cause transactions and dispositions of assets having a material effect as defined in subparagraph (A) and (B) of paragraph (2) on the issuer to be carried out consistent with the purposes of such paragraph. Such an issuer shall be conclusively presumed to have complied with the provisions of paragraph (2) by demonstrating good faith efforts to use such influence."

(Comment: see pp. 14-15 of the Written Statement).

Repealer: New Bribery Provision

Section 5. (No change)

Definitions

Section 6. (a) Section 13(b) of the Securities Exchange Act of 1934 is amended by adding at the end thereof the following:

"(6) for the purpose of this section, the term[s] 'reasonable detail' [and 'reasonable assurances'] means such level of detail [and degree of assurance] as 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.

(Comment: see pp. 10-12 of the Written Statement).

"(7) For the purpose of paragraphs (b)(2), (4), and (5) of this section, a matter is 'material' to the extent that a prudent man would be likely to consider the matter important in the management of his own property [the term 'material' is used in the same sense as in generally accepted accounting principles when those principles are applied to the preparation and presentation of financial statements of the issuer]."

(Comment: see pp. 18-25 of the Written Statement).

"(8) For purposes of paragraphs (2), (4) and (5) of this section, the term 'books, accounting records and accounts' means those books, records and accounts that are created in the processing of corporate transactions, including dispositions of assets, liabilities, and equities, and in the handling of corporate assets."

(Comment: see pp. 12-14 of the Written Statement).

(b) The Business Practices and Records Act is amended by inserting after Section 104 the following:

"(g) (No change)

"(h) (No change)

Exclusivity Provision for Overseas Bribery

Section 7. Section 104 of the Business Practices and Records Act shall be the exclusive provision under the laws of the United States authorizing a civil or criminal proceeding by the United States against a domestic concern, or any officer, director, employee, or shareholder thereof acting on behalf of such domestic concern, for making use of the mails or any means or instrumentality of interstate commerce in the manner and for the purposes proscribed by such section or for actions of a domestic concern which are taken in furtherance of such conduct; provided, however, that nothing in this Section shall limit the applicability of the provisions of the federal securities laws with respect to conduct that would also violate Section 104.

(Comment: see pp. 31-32 of the Written Statement).

Authority to Issue Guidelines

Section 8. (No change in subsections (a) through (d)).

"(e)(1) (No change)

"(2) On September 1 of each year the Chairman of the Securities and Exchange Commission shall file with the Congress a detailed report on all actions which the Commission has taken pursuant to paragraph [Section] 13(b) (2), (4), (5), (6), or (7) of the Securities Exchange Act, its views on problems associated with implementation, its plans for the next fiscal year to further implement such paragraphs, [section,] and its recommendations for amendment."

(Comment: These changes make clear that the report in question does not encompass Commission proceedings involving paragraphs 13(b)(1) and (3) of the Securities Exchange Act which long pre-date, and are unrelated to, the Foreign Corrupt Practices Act).

Conforming Changes in Internal Revenue Code

Section 9. (No change)

International Agreements

Section 10. (No change)

Section 11. Section 24(a) of the Securities Exchange Act of 1934 is amended by deleting therefrom the word "otherwise" and inserting in lieu thereof the following:

"otherwise; provided however, that any materials which are received by the Commission in any investigation or inquiry permitted by the federal securities laws as defined in Section 21(g),

or the rules and regulations adopted thereunder,
and which is provided pursuant to any compulsory
process under this Act or which is provided volun-
tarily in place of such compulsory process shall be
exempt from disclosure under Section 552 of title
5, United States Code."

(Comment: see pp. 28-31 of the Written Statement).