STATEMENT OF THE HONORABLE RODERICK M. HILLS
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BEFORE THE SUBCOMMITTEE ON CONSUMER PROTECTION
AND FINANCE OF THE HOUSE OF REPRESENTATIVES
COMMITTEE ON INTERSTATE AND FOREIGN COMMERCE

(September 21, 1976)

Mr. Chairman, members of the Subcommittee:

I appreciate this opportunity to testify on the need for legislative action dealing with the problem of questionable and illegal corporate payments and practices and, specifically, to offer the Commission's view on H.R. 15481.

The Commission's substantial efforts to deal with this problem are well documented in our May 12, 1976 Report to the Senate Banking Committee. Since that date, approximately 90 additional corporations have made disclosures of questionable or illegal payments and related practices engaged in both in this Country and abroad. There are today, therefore, more than 200 corporations, many of them among the largest in the Nation, which have made disclosure of these so-called questionable practices. These new disclosures follow essentially the same pattern we described in our May 12 Report.

As before, the most commonly reported transactions were payments to foreign officials made in an effort to procure the enactment or favorable application of advantageous tax, customs, or other laws; to assist companies in obtaining or retaining government contracts; to persuade low-level government officials to perform their regular functions; or to meet extortionate demands by foreign government officials. Many companies have indicated that "facilitating" payments to low-level officials are

customary and legal in certain parts of the world and that continuation of such payments is necessary in order to transact business.

The next most prevalent transaction, reported by 50 percent of the recent registrants, involves foreign commercial payments made in a manner suggesting impropriety. Excessive sales commissions, over-compensated foreign business agents or consultants, or inflated invoicing to facilitate kickbacks to buyers' purchasing agents were recurrent techniques used to obtain business. These payments were channelled directly to the management or procurement officer of prospective private-sector buyers, or took the form of excess commissions or consultant's fees to be passed on as payoffs to government officials with intent to influence government contract decisions.

Foreign political contributions were reported by 20 percent of new registrants, but many of these contributions were allegedly legal. In most instances, the payments had nonetheless been inaccurately reflected in company books and records.

Disclosures relating to domestic transactions have been less frequent. Although roughly one-quarter of the companies admitted making domestic political contributions, these payments were generally small and were made at the state and local level where they were often legal. Of greater concern is the revelation that 20 percent of the firms engaged in domestic commercial bribery, most often achieved through improper rebates or kickbacks to purchasers of goods or services.

As noted in our May 12th Report, most instances of reported abuse involved either the falsification of corporate records or the maintenance of incomplete records. Fifty percent of the companies disclosed such inaccuracies, ranging from deceptive descriptions of disbursements to the maintenance of substantial off-book accounts.

Although in many instances top management had knowledge of some of the questionable or illegal payments and accounting practices, official disciplinary action was rarely taken.

Since May 12th, the Commission has instituted three significant enforcement actions against corporations which have made unlawful payments. In one case, top management actively approved $330,000 in unlawful domestic political contributions, as well as payments to overseas trade association officials for use in obtaining a price increase from a foreign government. The two other actions were instituted to enjoin unlawful commerce bribery involving $6 million in payments channeled to prospective private-sector purchasers and more than $330,000 to influence government commercial policy and contract decisions. All these companies had materially falsified their books and records to conceal these improprieties.

Each corporation has consented to the entry of a permanent injunction against future violations of the securities laws. The consent decrees also authorize independent audit committees to investigate further irregularities, and the Commission has supported one Audit Committee's petition for judicial relief when a defendant refused to cooperate in supplying specified information. The Commission has several pending inquiries into similar matters, and additional enforcement actions are expected to be commenced shortly.

To summarize, we have found millions of dollars of corporate funds placed in hidden accounts and expended entirely at the discretion of corporate executives who caused or permitted the payments to be inaccurately recorded on corporate books. The creation of these hidden funds and the making of questionable and illegal corporate

payments from these funds were, in almost every case, concealed from outside directors and independent auditors.

It is important, of course, to make distinctions among these companies. It is quite true that in some cases the payments were made cynically and arrogantly by top corporate officials who knew they were acting contrary to existing laws and regulations and without the authority of their board of directors. Indeed, they went to great lengths to conceal their conduct from outside auditors, directors and shareholders.

But it is equally true that in a very large number of cases the sums of money have been relatively small and were made by persons at a much lower level of management who concealed their own activities from their superiors. In many cases which fit this latter classification top management has been able, on its own, to diligently ferret out such practices and put an end to them.

Unfortunately, the distinctions between these different types of corporate misconduct have not been made sufficiently clear to the public. It has been all too easy to lump all of these companies into one category, to consider them all as part of the same problem, and to brand the management of all of them as wrongdoers.

What we do see in all of these cases, on the basis of our two-year effort, is the sobering fact that this Country's system of protection for investors, developed over the past 40 years, and which includes corporate self-regulation with independent auditors, outside directors and counsel, and which is ultimately enforced by the Securities and Exchange Commission, has been seriously frustrated. Whether we speak of the relatively few cases in which top management has intentionally spent millions of dollars in large scale bribery, or of the more numerous cases in which lesser employees bolstered their

own performance records with kickbacks and so-called “grease” payments, the universal fact is that our system missed it for far too long.

The judgment now to be made by this Congress is whether that system in which the Securities and Exchange Commission has played the central role can be corrected or whether it must be replaced. H.R. 15481 would, in our judgment, provide a satisfactory correction of the system which we believe has worked overall to the great benefit of American investors in particular, and the American public in general.

We urge its passage.

By far, the most important argument in favor of this approach to legislation is the extraordinarily effective enforcement record of the Commission’s staff. Each of us may be concerned that these practices now uncovered have continued for so long, but it is equally important to emphasize the point that the problem has now been uncovered.

We have reaffirmed, at least to the satisfaction of the Commission, the American approach to securities regulation predicated upon the Acts of 1933 and 1934, which, as it now stands, is the most effective system in the world. Accordingly, our joint effort, that of the Congress and the Commission, now should be to take those steps which are sufficient to prevent a renewal of the problem and to similarly prevent other undersirable corporate practices from beginning unnoticed.

Proper concern has been expressed by the public, the press and members of Congress that there will come a time when the public and the press will lose interest in the matter of corporate bribery, and when the Commission’s staff may not be as alert as it has been in recent history. These commentators ask for tougher and stronger laws to protect against such an eventuality. In responding to such comments, we need to

emphasize the point that in the recent problem of corporate bribery and, indeed, in most cases of corporate misconduct, the failure can be traced to a failure in corporate accountability: accountability to outside auditors, outside directors, outside counsel and, ultimately, to outside shareholders. The Commission's program for correction is based on a threefold approach. First, we recommended in our Report of May 12th that legislation be enacted which would

-- require every issuer subject to the periodic reporting requirements of the Securities Exchange Ac to maintain accurate books and records;

-- require such issuers to maintain a system of internal controls capable of meeting certain objectives;

-- prohibit any person from falsifying the accounting records of any such issuer; and

-- prohibit any person from making a false or misleading statement, or omitting to state a material fact, to an accountant in connection with an audit of such an issuer.

The Senate Committee concurred and these provisions are embodied in Section 1 of the bill that passed the Senate, and which is identical to the bill now being considered by this Subcommittee.

The enactment of this legislation will, first of all, demonstrate a strong, affirmative Congressional endorsement of the need for accurate corporate records and effective internal control measures, and of the unacceptability of deception or obstruction

of auditors. Such an endorsement will effectively end any uncertainty about the Commission's role and approach to solving the problem and will unquestionably make far easier the criminal prosecution of corporate officials who intentionally violate the mandate of the proposed legislation.

The second, and equally important, effort of the Commission has been to implement a "new accountability" of the management of our major publicly-held corporations. Essential ingredients of this concept include creation of a new independence on the boards of directors of these companies, and a new recognition of the professional responsibility of the outside auditors and attorneys who deal with these publicly-held companies. Our first effort was to seek an initiative from public accountants and auditors. In response, the Auditing Standards Executive Committee of the American Institute of Certified Public Accountants has proposed a new articulation of accountants' responsibilities with respect to "Illegal Acts by Clients." That proposal, which we expect to be finalized shortly, discusses how accountants may become aware of illegal acts by their clients, the inquiries that should be made whenever such conduct is suspected, and the procedures that should be followed in beginning such suspected conduct to the attention of a level of management that deals with such suspicions.

Our second initiative in this respect was our letter to William Batten, the Chairman of the New York Stock Exchange. That letter emphasized our concern and asked the Exchange to consider the feasibility of establishing audit committees for listed companies which would be composed of outside directors who would, as a practical matter, be able to deal with questionable conduct uncovered during the course of an audit, and review auditing procedures. We suggested that such an objective could be reached if

the Exchange would add appropriate conditions to its listing requirements. We were pleased at the response. The board of directors of the New York Stock Exchange, on September 2, proposed that all listed corporations be required by the rules of the Exchange to maintain audit committees of the kind which we suggested. An important part of their proposal is to exclude from membership on that outside audit committee lawyers who are company counsel and who therefore are necessarily involved to some extent with the management of the company.

We are optimistic that this concept of outside audit committee will be created and that this step and similar steps taken by the Stock exchange will cause a far higher sense of corporate accountability to evolve in American business.

I should add that over the last ten years such an evolutionary process has been going on. Corporations such as General Motors, Xerox, Connecticut General and Texas Instruments have already established independent audit committees which have created the type of corporate accountability which we believe to be important for the American business community.

I should also add that many of the corporations that have been the subject of our enforcement actions, to date, in the field of questionable payments did not at the time have outside audit committees of this type.

The third part of our effort to respond to the problem uncovered is to create an effective international effort to protect American corporations, which play by the rules which the Commission is charged with enforcing, against the unfair competition of foreign institutions which do not play by the same rules.

To some limited degree, the Commission can play a role in that effort by making certain that the disclosure requirements which we impose upon American businesses are similarly imposed upon foreign businesses which are using our capital markets, either by securing a listing on the Stock Exchange or by seeking funds in the United States from our investors. To date, approximately six major foreign-based companies have made the same kinds of disclosure with respect to questionable payments, as have the approximately 200 American corporations.

At present, efforts of the Executive Branch of our Government to secure an international agreement with respect to these questionable payments will be an added protection for American business.

I personally believe an additional step can be taken. A determined effort by those Executive Branch agencies which deal with international business activities to identify unfair practices abroad can effectively discourage such practices. Obviously, such an effort has many ramifications with respect to our foreign relations, but I am convinced that it can produce material results and I am hopeful that such an effort will develop over the months ahead.

In conclusion, I would like to comment briefly on the remaining provisions of H.R. 15481. Section 2 would amend the Securities Exchange Act by adding a new Section 30A to that Act, prohibiting issuers registered with the Commission from making certain types of payments to foreign governments, officials, or political parties. Section 3 of the bill would enact a similar prohibition, separate from the securities laws, and applicable to any domestic concern other than any issuer which is subject to proposed Section 30A.

While the Commission does not oppose direct prohibitions against these payments, we have previously stated that as a matter of principle, the Commission would prefer not to be involved even in the civil enforcement of such prohibitions. As a matter of long experience, it is our collective judgment that disclosure is a sufficient deterrent to the improper activities with which we are here concerned. Having made this point, however, let me say that the Commission recognizes the Congressional interest in asserting these rules in the form contained in Sections 2 and 3, and because of this particularly pressing concern, we do not object to their inclusion in the final legislation.

We are obviously passing through an unhappy chapter in the history of American business, but it is important to stress the point that the misconduct of some corporations does not warrant the broad condemnation of the entire business community. Competition based upon price and the quality of the product rather than on hidden bribes, kickbacks and "grease" payments, remains the hallmark of private enterprise in this Country. The aggressive desire, with few exceptions, of the boards of directors of the companies that have uncovered questionable practices, to eliminate such practices, is a testament to that point.

The lesson to be learned from our experience is that increased corporate accountability to the boards of directors and to stockholders will strengthen the quality and morality of corporate management and will increase public confidence both in the business community and in the integrity of this Nation's capital markets.

Again, I appreciate this opportunity to present the views of the Securities and Exchange Commission on the important issues which this Subcommittee is studying. I will be pleased to respond to any questions you may have.