AMERICAN BAR ASSOCIATION

SECTION OF CORPORATION, BANKING AND BUSINESS LAW

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INV 1-13

June 20, 1977

The Honorable Harley O. Staggers
Chairman of the House Committee
on Interstate and Foreign Commerce
2366 HROB
Washington, D.C. 20515

Re: H.R. 1602 and S. 305; and H.R. 3815

Dear Congressman Staggers:

This letter is submitted on behalf of the Section of Corporation, Banking and Business Law of the American Bar Association. Although it represents the position of the Section, it does not necessarily constitute the official position of the American Bar Association. An earlier version of this letter dated April 19, 1977, was submitted to the Honorable Bob Eckhardt, Chairman of the Subcommittee on Consumer Protection and Finance of your Committee by members of the Federal Regulation of Securities Committee. The earlier letter was sent in advance of obtaining the official authorization of this Section since it was felt desirable to have the views of our members before the Subcommittee without undue delay.

We note that since transmittal of the April 19 letter to the Subcommittee, the Subcommittee has referred the above-referenced legislation to your full Committee. We also note that the Senate has passed S. 305, which deals with the same subject matter as H.R. 1602 and H.R. 3815. Consequently, we feel it desirable to place our views on this legislation before you at this time. This letter was prepared on behalf of the Section by our Federal Regulation of Securities Committee and its Ad Hoc Subcommittee on Foreign Payments Legislation.

I. H.R. 1602 and H.R. 3815

A. Introduction

H.R. 1602, introduced by Congressman Murphy, would

prohibit foreign bribery and would require issuers of securities registered pursuant to Section 12, and issuers filing reports pursuant to Section 15(d), of the Securities Exchange Act ("Reporting Companies") to maintain accurate books and records and to maintain an adequate system of internal accounting controls.

H.R. 1602 is virtually identical to Title I of S. 305 introduced by Senators Proxmire and Williams. Neither H.R. 1602 nor H.R. 3815 includes provisions comparable to Title II of S. 305 which provisions would require increased reporting concerning the ownership of registered equity securities.

B. Comments on Sections 2 and 3 of H.R. 1602 and on H.R. 3815

We support, without reservation, the goal of eliminating foreign bribery. We agree that legislation designed to restore and maintain confidence in American business at home and abroad is desirable. However, legislation which assumes that a multinational corporation will be able to prevent all corrupt offers or promises by every employee, including foreign nationals whose concepts of business morality differ from our own, is unrealistic. Until the ethical precepts which we share with the sponsors of the legislation have been accepted not only by the American business community but also by the governments and businessmen with whom our business community must deal throughout the world, no effort to eliminate foreign bribery can be expected to be completely successful.

The lessons of history should not be ignored. As illustrated by Prohibition, making conduct criminal in an environment in which the legislation has neither the universal support nor the effective policing mechanism necessary for enforcement breeds disrespect for law, thus weakening the confidence in American business the legislation is intended to promote. Because we share the serious concern about the enforcement problems of S. 305 expressed by Secretary Blumenthal in his statement before the Senate Banking Committee on March 16, 1977, we believe that the conduct is engaged in with the approval or actual, rather than constructive, knowledge of the corporation's directors and executive officers. If, on the other hand, such conduct reflects the inability of senior management to completely control the significant activities of lower level employees, a requirement of disclosure to the shareholders will promote the

aims of the legislation without the problems of enforcement inherent in making the corporation criminally accountable for its inability to exercise complete control over the activities of all of its employees.

In addition to H.R. 1602 and H.R. 3815, we have reviewed proposed legislation of the Carter Administration which would amend Sections 103 and 104 of S. 305. Based on our review of these varying approaches, we urge that any law criminalizing foreign bribery:

1. not be included in the Exchange Act since it would detract from the concept of financial materiality to investors which has been inherent in the Federal securities law disclosure structure and has made possible the high levels of voluntary compliance with those laws which has traditionally existed;

2. be included in the U.S. Criminal Code rather than introduced as an unrelated substantive criminal provision in the Exchange Act;

3. provide for uniform enforcement by the Department of Justice for all companies, whether or not they are publicly owned, rather than inviting the inconsistent enforcement and costly and inefficient duplication inherent in dividing responsibility between the Department of Justice and SEC; and

4. expressly exclude (i) low-level "facilitating" payments and (ii) legitimate payments to promote business and generate good will, rather than rely on subsequent interpretations of the term "corruptly."

We generally prefer the legislation proposed by the Carter Administration because it achieves all of the above objectives except the last one.

Although the exclusion in H.R. 3815 of ministerial and clerical employees from the definition of "foreign officials" is desirable, we believe it does not go far enough in dealing with the first portion of objective 4 listed above. The Administration's proposal and H.R. 1602 add the essential ingredient by providing that the purpose of such payments must be to assist in obtaining or retaining business with a foreign

government, to direct foreign government business to any person, or to influence legislation or regulations of a foreign government. Similarly, the Administration's proposal and H.R. 1602 need the exclusion of ministerial and clerical employees found in H.R. 3815.

C. Comments on Section 1 of H.R. 1602

We favor the approach in H.R. 3815, which omits the accounting and related provisions contained in Section 1 of H.R. 1602 (and the identical Section 102 of S. 305), thereby recognizing the preferability of allowing the SEC to adopt rules to regulate the accounting and related matters in issue.

We hold this view even though the Committee has objections to the SEC's proposal. These objections are reflected in the Committee's comment letter to the SEC which questions whether the agency has authority to adopt such rules and suggests language changes. Accordingly, our favoring of the approach taken by your bill, that these accounting regulations are best left to administrative rulemaking which has the necessary greater flexibility, is conditioned on whether the SEC adopts its proposed accounting rules.

In any event, if the subject accounting provisions are to be adopted by means of legislation, we urge consideration of the following suggestions concerning Section 1 of H.R. 1602.

1. None of the three subsections of Section 1 excludes immaterial acts or transactions. This is inconsistent with the basic approach of the securities laws that the courts and the SEC should concern themselves only with material items. Although materiality may not be measured solely in terms of dollars, a matter can be insignificant because of size alone and therefore without adequate basis to justify the time or attention of the courts or the SEC.

2. Subsection (2) would require a Reporting Company to maintain an adequate system of internal accounting controls. The provision assumes that questionable payments are made possible by inadequate accounting controls. To the contrary, a common characteristic of the cases to date has been the deliberate circumvention of internal accounting controls. Accordingly, we suggest that any legislative solution focus on the observed evil. Creation of slush funds from which bribes are paid and the mislabeling (and therefore concealing) of

foreign bribes are necessarily the consequence of intentional acts which violate existing accounting control systems. If additional statutory requirements are in fact necessary, the language suggested below at the end of this part 2 as an alternative to Subsection (2) will adequately define, in our judgment, the class of persons who could undertake such schemes and create a statutory prohibition which focuses on the conduct which has given rise to concern on the part of the Congress and the SEC, without imposing on Reporting Companies the requirements included in Subsection (2) which are in part not clearly defined and redundant. Moreover, the suggested language would eliminate several drafting problems identified in our letter to this Subcommittee dated September 22, 1976.

We recognize that the language of Subsection (2) comes from existing auditing guidelines. However, language which may provide appropriate guidelines for accountants and define the objective of accounting controls is not necessarily appropriate for inclusion in a statute, the violation of which carries civil and criminal penalties.

Although we believe all issuers should maintain "an adequate system of internal accounting controls," we do not believe that as a matter of fundamental fairness the failure to do so should be made the subject of Federal civil and criminal penalties in the absence of clearly articulated standards as to what would constitute an adequate system. The components of such a system are not contained in the accounting literature. Thus, adoption of this portion of the bill in its present form would provide inadequate guidelines to issuers as to when they are operating unlawfully. Given the difficulty inherent in establishing and defining an adequate system for all categories of issuers, we do not understand the pressing need to legislate this aspect of public accounting, particularly where the foreign payment situations disclosed to date have had almost the universal characteristic of circumvention of apparently adequate internal accounting systems. A far better approach--one tailored to the actual problem--would be to prohibit circumvention of an internal system of accounting controls.

In view of the foregoing, we suggest as an alternative to Subsection (2) the following language:

> "(2) It shall be unlawful for an officer, director or employee of an issuer which has a class of securities registered pursuant to section 12 of this title or which is required to furnish reports pursuant to section 15(d)

> of this title to circumvent, with intent to deceive as to a matter involving $1,000 or more, the system of accounting records and internal accounting controls maintained by such issuer to record its transactions and account for its assets."

3. Subsection (3) would make it unlawful to falsify accounting books and documents. This provision does not require any intent to do an improper act, does not make any exception for immaterial inaccuracies and is not limited to persons having a management or employment relationship with the issuer. Items as trivial as a carelessly prepared expense voucher presumably would be included. Another effect of this Subsection would be to make willful falsifications of any accounting document a felony under Federal law wholly irrespective of the amount involved.

According to the Senate Report on S. 3664, the Proxmire bill in the 94th Congress, traditional concepts of aiding and abetting and joint participation in a violation would apply. If this provision is not limited to persons connected with the issuer, we believe that this would result in a dangerously broad area of potential liability with undefined boundaries that would serve no commensurate useful purpose.

To address these negative consequences we suggest this Subsection read as follows:

> "(3) It shall be unlawful for any officer, director, employee or agent of any issuer which has a class of securities registered pursuant to section 12 of this title or which is required to file reports pursuant to section 15(d) of this title, directly or indirectly, to falsify, or cause to be falsified, with intent to deceive as to a matter involving $1,000 or more, any book, record, account or document of such issuer made or required to be made for any accounting purpose."

We wish to suggest one additional point. As set forth in the next part of this letter, we believe the sort of prohibition contained in Subsection (3) is more appropriate for inclusion in the U.S. Criminal Code.

4. Subsection (4) would make it unlawful for any person to make false or incomplete statements to an accountant in connection with any audit of a Reporting Company. This provision would be counterproductive in our opinion because it would discourage communications with auditors in many cases. Because this Subsection does not require any intent to do an improper act, does not make any exception for immaterial inaccuracies, and applies to the most casual oral statements, banks, suppliers and customers from whom auditors normally seek information in connection with an audit but who have no obligation to furnish it might well decline to furnish any information to the auditors rather than run the risk of an inadvertent violation of a civil and criminal statute.

For the above reasons, we believe Subsection (4) should apply only (i) to persons with specified relationships to the Reporting Company, and (ii) to a written communication containing a material defect which is made with an intent to deceive.

In order to reflect the above comments and for increased clarity of expression in certain other respects which do not involve any change of substance, we suggest that Subsection (4) read as follows:

> "(4) It shall be unlawful for any officer, director, employee or agent of any issuer hereinafter described, with intent to deceive, directly or indirectly
>
> (a) to make, or cause to be made, in writing an untrue statement of a material fact, or
>
> (b) to omit to state, or cause another person to omit to state, any material fact necessary in order to make statements made in writing by such officer, director, employee or agent, in the light of the circumstances under which they were made, not misleading,
>
> to an accountant in connection with any audit of the financial statements of an issuer which has a class of securities registered pursuant to section 12 of this title or which is required to file reports pursuant to section 15(d) of this title, or in connection with any audit of

> the financial statements of an issuer with respect to an offering registered or to be registered under the Securities Act of 1933."

As in the case of Subsection (3), we believe that in view of the nature of this statutory provision it should be included in the U.S. Criminal Code, if adopted at all, and not be added to the Exchange Act. This would also readily permit these provisions to be made applicable to all issuers and not merely to Reporting Companies.

II. Title II of S. 305

A. Comments on Section 202

Section 202 of Title II would require disclosure of the residence and nationality of 5% beneficial owners of registered securities. We believe this added disclosure would be beneficial. However, such disclosure is already required by rules adopted by the SEC which become effective on August 31, 1977, and we are aware of no reason for substituting a new statutory requirement.

B. Comments on Section 203

Section 203 as originally drafted could establish a new reporting requirement for holders of record of as little as one-half of 1% of a registered equity security. As of this writing, however, this provision has undergone substantial amendment by the Senate Banking Committee to, among other things, maintain the reporting threshold at 5%. We favor Section 203, as amended, assuming the Congress determines that legislation in this area is needed at all.

If it is considered advisable, we would be pleased to meet with you or members of the staff of the Subcommittee to discuss these comments in greater detail.

Respectfully submitted,

William E. Hogan

William E. Hogan, Chairman
Section of Corporation, Banking
and Business Law

cc: √ Hon. William Proxmire
Hon. Harrison A. Williams
Hon. W. Michael Blumenthal
Hon. Harold M. Williams
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