SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

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BEFORE THE
SUBCOMMITTEE ON
INTERNATIONAL ECONOMIC POLICY AND TRADE
COMMITTEE ON FOREIGN AFFAIRS
U.S. HOUSE OF REPRESENTATIVES
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I. Introduction

I appreciate the opportunity to testify concerning H.R. 2157, the "Foreign Trade Practices Act of 1983." Portions of the bill would amend the accounting and anti-bribery provisions of the Securities Exchange Act of 1934, which were added by the Foreign Corrupt Practices Act of 1977.

To the extent H.R. 2157 is similar to S. 414, the Business Accounting and Foreign Trade Simplification Act, the Commission supports the objectives of the pending bill as to the substance of the accounting provisions.[1] In this regard, the two bills, like a predecessor bill, S. 708, would eliminate ambiguities and simplify the administration of

[1] See Statement of the Honorable John S.R. Shad, Chairman, Securities and Exchange Commission, before Joint Hearings of the Subcommittee on Securities and the Subcommittee on International Finance and Monetary Policy of the Senate Committee on Banking, Housing and Urban Affairs concerning S. 414 (February 24, 1983).

the accounting provisions while preserving the objectives sought when the law was enacted.[2]

The Commission does not support (i) transferring administration of the accounting provisions of the FCPA from the Securities Exchange Act and the jurisdiction of the Commission to the Department of Commerce, or (ii) limiting the focus of the accounting provisions to "demonstrating compliance" with the anti-bribery provisions of the FCPA.

II. Background

The accounting provisions of the FCPA[3] require issuers: (a) to "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"; and (b) to "devise and maintain a system of internal accounting controls sufficient to provide reasonable assurances that …" certain statutory objectives are met.[4] The anti-bribery provisions[5] applicable to

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

[3] Section 13(b)(2) of the Securities Exchange Act of 1934.

[4] These objectives are reasonable assurances that:

> (i) transactions are executed in accordance with management's general or specific authorization;
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> (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:
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> (iii) access to assets is permitted only in accordance with management's general or specific authorization; and

(Footnote Continued)

issuers within the Commission's jurisdiction prohibit corrupt payments or gifts to foreign officials, candidates for foreign political office and foreign political parties, which are made in order to obtain or retain business or direct business to another person.[6]

The Commission is committed to vigorous enforcement of the FCPA. The 34 cases brought to date reflect this commitment. We will continue to investigate violations of the accounting and anti-bribery provisions whenever it appears that illegal conduct has occurred. When the evidence warrants, appropriate enforcement action will be taken.

Financial statements and the disclosure of financial information are central to the disclosure system. No other aspect of the disclosure process has a greater impact on the judgments of investors and the market prices of securities.

Public confidence in the integrity of our markets is essential to capital formation and to our nation's economic growth and stability. The Commission's purpose is to insure that the nation's capital markets operate with an integrity that promotes investor confidence. The accounting provisions of the FCPA contribute to the attainment of the objective. However, ambiguities in these provisions which are unnecessary to their purpose have led to uncertainty by those who try to comply with the law, and to needless compliance costs.

As to the anti-bribery provisions, they represent a Congressional determination that when U.S. corporations compete in the international marketplace, they should

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(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.

[5] Section 30A of the Securities Exchange Act of 1934.

[6] The anti-bribery provisions also forbid payments to an agent while knowing or having "reason to know" that the payments will be passed to a foreign official for prohibited purposes.

compete with integrity on the basis of price, quality and the services they perform.[7] So long as this enforcement responsibility remains with the Commission, we shall continue to take appropriate action on facts of which we are aware.

III. The Commission's Enforcement of the FCPA

While the Commission supports legislation to clarify the accounting provisions of the FCPA, it has vigorously enforced the present law. We have initiated 32 enforcement actions under the accounting provisions, including 29 injunctive actions and three administrative proceedings. Twenty-three of the actions have been brought during the past two years.

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

Violations of the accounting provisions generally have been uncovered in connection with inquiries into possible violations of other provisions of the federal securities laws. Each of the 29 injunctive actions has involved allegations that the corporate defendant violated one or more disclosure requirements of the federal securities laws.

Most of the defendants or respondents named in the enforcement actions have consented to the entry of permanent injunctions against future violative conduct or other relief without admitting or denying the Commission's allegations. SEC v. World Wide

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[7] See H.R. Rep. No. 95-640, 95th Cong., 1st Sess. (1977) at 4.

Coin Investments, Ltd. is the first and only decision in a litigated case interpreting the accounting provisions.[8]

The Commission also has brought two enforcement actions to enforce the anti-bribery provisions of the FCPA.[9] Each included allegations of antifraud and disclosure violations.

During the past two years, the Commission has conducted 10 inquiries involving possible violations of the anti-bribery provisions. One has resulted in enforcement action, six were closed due to insufficient evidence that a violation had occurred, one matter was pursued by the Department of Justice and two are pending.

IV. The Need for Clarification of the FCPA

A lack of clarity exists in both the accounting and anti-bribery provisions. The ambiguities have generated a substantial degree of consternation among legislators, businessmen and prosecutors of utmost good faith.

Many of the concerns expressed to the Commission have arisen from difficulty in interpreting the reach of the accounting provisions of the FCPA. This concern over the lack of clarity exists on the part of financial executives, independent accountants, the securities bar and members of the Commission's staff.

In order for there to be meaningful and cost-effective compliance with our nation's laws, those laws should be understandable and easily interpreted. Businessmen

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[8] See SEC v. World Wide Coin Investments, Ltd. (N.D. Ga., Civil Action No. C-81-1642A, commenced Aug. 31, 1981; findings of fact and conclusions of law entered May 23, 1983).

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

and women want to comply with the law. The tendency of the law must be to reduce uncertainty.

Accordingly, the Commission continues to support legislation to clarify the law consistent with the purposes of the accounting provisions.[10] In addition, it has provided guidance concerning its interpretation of the accounting provisions in a formal Statement of Policy,[11] the promulgation of two rules[12] and various public releases.[13] The Commission also has supported the Department of Justice's efforts to afford guidance concerning the bribery prohibitions.[14]

The Commission has not had extensive practical experience with prosecutions of the anti-bribery provisions. Consequently, the Commission defers to the Department of Justice for analysis of the proposed amendments. However, before joining the Commission I had experience counseling regarding the anti-bribery provisions. I would be pleased to offer my personal observations in response to questions in this area.

V. The Accounting Provisions of H.R. 2157

A. The Purposes of the Accounting Provisions

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10 See supra, nn. 1-2.

11 Securities Exchange Act Release No. 17500 (Jan. 29, 1981), 46 F.R. 11544 (Feb. 9, 1981), 21 SEC Docket 1466 (Feb. 10, 1981).

12 The Commission adopted Rules 13b2-1 and 13b2-2 following enactment of the FCPA. Rule 13b2-1 prohibits any person from falsifying corporate records and Rule 13b2-2 prohibits corporate officers, directors and shareholders from misleading auditors.

13 See Securities Exchange Act Release No. 15570 (Feb. 15, 1979), 44 F.R. 10964 (Feb. 23, 1979), 16 SEC Docket 1143 (Mar. 6, 1979); Securities Exchange Act Release No. 15772 (Apr. 30, 1979), 44 F.R. 26702 (May 4, 1979), 17 SEC Docket 421 (May 15, 1979); Securities Exchange Act Release No. 16877 (June 6, 1980), 45 F.R. 10134 (June 13, 1980), 20 SEC Docket 310 (June 24, 1980).

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

Now permit me to specifically address the bill before this Subcommittee.

H.R. 2157 would make several substantive changes in the accounting provisions of the FCPA. In addition, it would (i) remove the accounting provisions from the Securities Exchange Act and the jurisdiction of the Commission, (ii) transfer their administration to the Department of Commerce, and (iii) limit the focus of the accounting provisions to "demonstrating compliance" with the anti-bribery provisions.

In 1976, the Commission recommended enactment of the accounting provisions in order to provide greater assurance that corporate accounting systems will be maintained in a manner that permits companies to fulfill their disclosure obligations under the securities laws. The Commission noted that the integrity and reliability of corporate books and records are the foundation of the disclosure system established by the federal securities laws.

The legislative history of the accounting provisions reflects agreement with this view. The Senate Report concerning the bill declares, "The purpose of section 102 is to strengthen the accuracy of the corporate books and records and the reliability of the audit process which constitute the foundations of our system of corporate disclosure."[15] The Report adds, "Public confidence in securities markets will be enhanced by assurance that corporate recordkeeping is honest."[16] Thus, while the Congress believed that the creation of "affirmative requirements" to maintain accurate records and adequate systems of internal accounting controls would "go a long way to prevent the use of corporate assets

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15 S. Rep. No. 95-114, 95th Cong., 1st Sess. (1977) at 7; See H.R. Rep. No. 95-831, 95th Cong., 1st Sess (1977) at 10.

16 Id.

for corrupt purposes," the deterrence of corporate bribery was not the only purpose of the legislation.[17] Therefore, H.R. 2157 is unduly restrictive in this regard.

Moreover, the Department of Commerce does not have the staff, including lawyers, accountants and investigators with expertise in accounting and the securities laws, that is essential to develop and prosecute financial fraud cases. Nor does the Department of Commerce have the means to uncover violations of the accounting provisions. The Commission generally discovers these violations in the course of investigating violations of the disclosure requirements of the federal securities laws. Such investigations may reveal improper recordkeeping or inadequate internal accounting controls that cause, or are associated with, violations of the disclosure requirements. In addition, administration of the accounting provisions does not appear to be related to any other responsibilities of the Department of Commerce. There would be unnecessary duplication of law enforcement initiatives. Under these circumstances, the Commission opposes the proposed transfer of administration of the accounting provisions to the Department of Commerce.

B. The Substance of Proposed Amendments to the Accounting Provisions

Apart from the proposed transfer of jurisdiction to the Department of Commerce, the proposed amendments to the accounting provisions are virtually identical to those contained in S. 414. The Commission stated its support of the amendments proposed in

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[17] Id. In the latter context, the Senate Report noted (p. 7) that the accounting provisions were "intended to operate in tandem with the . . . [antibribery] provisions of the bill to deter corporate bribery."

S. 414 in February 1983 before joint hearings of Subcommittees of the Senate Committee on Banking, Housing and Urban Affairs.[18]

Let me summarize what the two bills would accomplish. The Commission supports each of the proposed changes.

The proposed amendments would continue to require systems of internal accounting controls that provide reasonable assurances that the statutory objectives are met. They reflect a continued expectation that reporting companies will make and keep records which, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the issuer. However, a new definition would clarify the reasonable assurances standard by making clear that assurances are those "which a prudent individual would provide in the conduct of his own affairs, having in mind a comparison between benefits to be obtained from the system of internal accounting controls maintained and costs to be incurred in obtaining such benefits."

The cost-benefit test is presently referred to in the legislative history of the FCPA, but is not set forth in the statute. This test is consistent with the auditing standard which recognizes that "the cost of internal control should not exceed the benefits expected to be derived."[19]

While the proposed amendments would eliminate the existing recordkeeping provision, they would continue to make management responsible for providing reasonable assurances that corporate transactions are recorded accurately and in reasonable detail. As Statement on Auditing Standards No. 1 reflects, "The objective of

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[18] See n. 1, supra.

[19] Statement on Auditing Standard No. 1, Section 320.32. The auditing standard recognizes that "[t]he benefits consist of reductions in the risk of failing to achieve the objectives implicit in the definition of accounting control."

accounting control with respect to the recording of transactions requires that they be recorded at the amounts and in the accounting periods in which they were executed and be classified in appropriate accounts."[20] Moreover, the Senate bill would prohibit the knowing circumvention of a system of internal accounting controls. This would include the deliberate falsification of books and records or other purposeful conduct calculated to evade the internal accounting controls requirement.

The proposed legislation would reduce undue compliance costs by making clear, in the language of the statute, that no criminal liability will result solely from failure to comply with the internal accounting controls requirement. No such prosecutions have been brought to date. However, a criminal prosecution could be brought on the basis of other provisions of the securities laws, if a violation of the internal accounting controls requirement occurs in connection with criminal violations of other provisions, such as the failure to disclose material information in a securities transaction.

The bill also would make clear that no civil injunctive relief may be imposed with respect to an issuer for failing to comply with the accounting provisions if it can show that it acted in good faith in attempting to comply with the internal accounting controls requirement. This is consistent with the Commission's 1981 Policy Statement.[21]

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[20] Section 320.38.

[21] The 1981 Policy Statement declares:

> "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."

The Commission's 1981 Policy Statement, 21 SEC Docket at 1470.

Persons other than an issuer would not be subject to civil injunctive relief in connection with an issuer's violation, unless they knowingly caused an issuer to fail to devise or maintain an adequate system of internal accounting controls. While this amendment has no counterpart in the present law, it also is consistent with the Commission's 1981 statement of policy.[22]

The proposed legislation also would clarify the extent to which issuers may be held responsible when they hold 50 percent or less of the voting power with respect to a domestic or foreign firm. The bill would require that an issuer proceed in good faith to use its influence, to the extent reasonable under the issuer's circumstances, to cause such a firm to comply with the internal accounting controls requirement.

C. The Ant-Bibery Provisions

The FCPA also charges the Commission with responsibility for civil enforcement of the prohibition against the bribery of foreign government officials and others by issuers. This prohibition reflects a Congressional determination that bribery of foreign

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[22] The 1981 Policy Statement observes:

> "[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." 21 SEC Docket at 1471.

Courts have construed the word "knowingly" to include "reckless" conduct.

The Policy Statement adds:

> "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." (Id.)

officials is illegal and should be eradicated.[23] The Commission has sought to carry out this "national commitment of ending corrupt foreign payments."[24]

The Commission's traditional mandate with respect to issuers of securities is, however, investor protection through full disclosure. Unlike the accounting provisions, the bribery prohibition has no direct nexus to that mandate. Accordingly, the Commission made clear, prior to enactment of the FCPA, that the prohibition of foreign bribery raised important issues of national policy unrelated to the objectives of the securities laws. Former Commission Chairman Hills recommended to the Senate Banking Committee that, if Congress chose to outlaw such transactions, it should not do so under the federal securities laws.[25] Congress decided, however, to assign to the Commission responsibility for civil enforcement of the bribery prohibitions applicable to issuers, and assigned criminal enforcement to the Department of Justice.

Because the Commission's primary mission is disclosure, not substantive regulation of day-to-day business transactions, removal of the Commission's jurisdiction with respect to the anti-bribery provisions would not impair the Commission's ability to administer the securities laws. In instances where foreign bribery involves a failure to disclose information which is material to investors, the Commission would retain its authority to take appropriate action.[26]

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23 See H.R. Rep. No. 95-640, supra n. 7 at 4-6.

24 S. Rep. No. 95-114, supra at 10.

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

26 See remarks of John M. Fedders, Director, Division of Enforcement, Securities and Exchange Commission, to a meeting of the Federal Regulation of Securities Committee of the American Bar Association's Section of Corporation, Banking and Business Law, Washington, D.C., concerning law enforcement against those who fail to disclose illegal behavior (November 19, 1982).

For these reasons, the Commission, in its testimony concerning S. 414, did not oppose proposed amendments which would transfer enforcement authority under Section 30A to the Department of Justice. In addition, the Commission has deferred to the Department of Justice with respect to the substance of proposed amendments to the anti-bribery provisions.

VI. Conclusion

A substantial majority of business officials want to comply with the law. They are entitled to a clear and unambiguous law that may be complied with in a cost-effective manner. The vagueness of the present law should be eliminated.

The efforts to clarify the FCPA have brought disagreement to the surface. The problems present opportunities. It is now important that a consensus be reached and the FCPA be clarified.