MEMORANDUM

January 23, 1981

TO: The Commission

FROM: Paul Gonson PG
Solicitor

Frederick B. Wade FBW
Senior Special Counsel

RE: The Commission's Comments in Response to the GAO Draft Report Concerning the FCPA

We have revised the Commission's comments with respect to the GAO's draft report concerning the FCPA in accordance with the instructions the Commission gave us on Monday, January 19, 1981, and transmitted those comments to the GAO earlier today. A copy of the comments is attached for the Commission's information.

Late Monday afternoon, we received a letter from Phillip B. Heymann, the Assistant Attorney General for the Criminal Division of the Justice Department, which sets forth the Department's views with respect to the discussion of the bribery prohibitions contained in the draft which the Commission considered Monday morning. A copy of Mr. Heymann's letter is also attached. As the Commission directed, we have made changes in response to the Department's concerns and have been advised by a representative of the Department that the Department's concerns have been satisfied. In addition, although the Department's comments will not discuss the accounting provisions, the Department's representative has indicated that he does not object to the views the Commission expresses with respect to those provisions.

SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

OFFICE OF THE
GENERAL COUNSEL

January 23, 1981

MEMORANDUM

TO: D. L. Scantlebury
The General Accounting Office

FROM: Ralph Ferrara, General Counsel
The Securities and Exchange Commission

INTRODUCTION

The Securities and Exchange Commission has authorized me to transmit to you its views with respect to the draft report of the General Accounting Office ("GAO") concerning the implementation and impact of the Foreign Corrupt Practices Act ("FCPA"). We respectfully request that you transmit this memorandum together with your report to the Congress.

The completion of the GAO study is an important event. The GAO's survey of 250 industrial corporations establishes an empirical data base which provides information that will assist the Commission, the Justice Department and the Congress in assessing the impact and implementation of the FCPA. As a result, the GAO's report constitutes a significant contribution to discussions concerning the impact and meaning of the Act.

We realize there is a widespread perception that the FCPA is causing difficulties for American business. To the extent that companies no longer may pay bribes to foreign officials in order to obtain or retain business, or hide such payments in "off-the-books" slush funds, these results are among the principal intended purposes of the Act. To the extent that there may be other problems that are unintended, however, the Commission agrees that they should be remedied so that businessmen who wish to conduct their business in accordance with the requirements of the Act can comply with the law without encountering undue burdens. What is striking about the data on which the draft report is based is the fact that the empirical evidence does not support the widespread perceptions of difficulties. If the data are reliable (and there may be some questions as to that), the rhetoric concerning ambiguities and difficulties does not appear consistent with the reality. As a result, the controversy surrounding the FCPA may well be a case in which conventional wisdom lacks a basis in hard fact. Nevertheless, the Commission wishes to make clear that it stands ready to support reasonable proposals for assisting the business community, in a manner consistent with the intended purposes of the law, in complying with the requirements of the Act.

Although new legislation often has rough edges that can only be polished by the forces of time and practical experience, the results of the GAO survey are quite positive. The survey data indicates that the FCPA has been a remarkable success and that many companies felt it necessary, in light of

the enactment of the FCPA, to make important changes in their audit and internal accounting control functions, and in their codes of conduct, despite the fact that a large number had already made changes in these areas in the four years prior to enactment of the statute. The data suggest that in the absence of the statute serious deficiencies would have remained uncorrected. The data also indicate that the bribery prohibitions of the Act have been effective in reducing corporate bribery of foreign officials and that these results have been achieved without serious losses of overseas business.

The draft report correctly points out that the FCPA has been the subject of controversy in the three years since the statute was enacted. It also notes allegations of some persons that key terms of the Act are ambiguous and confusing and recommends consideration of possible steps that could be taken to alleviate the concerns that have been expressed. In this context, the Commission recognizes that implementation and interpretation of the FCPA involves the consideration of several difficult issues. In addition, although the Commission has a number of reservations about the discussion set forth in the draft report, it welcomes the completion of the GAO's draft report because it has provided the occasion for the Commission to address important issues concerning the FCPA, and assisted the Commission in clarifying its own views, in light of the survey data.

Although our comments are rather lengthy, we believe that the GAO will find our views constructive and helpful. Our comments seek to put the Act and its legislative history in perspective, to explain why many of the criticisms of the Act are either misplaced or exaggerated and to emphasize the importance of going beyond the assertions of some persons that the Act is confusing and ambiguous to an analysis of competing policy considerations and an effort to reconcile these competing considerations in a manner that is consistent with the purposes of the Act. In addition, our comments concerning the draft report eludicate the Commission's position with respect to important points in a manner that we hope will lead to a greater understanding of the impact and meaning of the Act. In this context, we believe it would be useful for the GAO to include a more detailed assessment of the merits and shortcomings of the criticisms that have been leveled at the Act in order to assist the Congress in evaluating the important issues that exist concerning the FCPA.

Our comments are set forth below with respect to each of the four chapters in the GAO's draft report. Please note, however, that any changes made in response to our comments may also have to be made at appropriate places in other portions of the draft, as well as in the cover summary and the digest.

Chapter 1: PERSPECTIVE

A. Reasons for Enactment of the Bribery Prohibitions of the FCPA

We can well understand the desire for relative brevity in the report, and we are of course aware of the length of this response. But a more de-

tailed background explanation is necessary, in our view, for a proper understanding of the issues dealt with in the draft report. There is, for example, only a single sentence concerning the reasons for enactment of the bribery provisions, which states that "the Congress perceived corporate bribery as (1) unethical, (2) unnecessary to the successful conduct of business, and (3) harmful to our relations with foreign governments." There is no attempt to provide an appreciation of the costs for the nation and American business that the Congress viewed as resulting from corporate bribery.

The legislative history reflects that a primary concern of Congress was the fact that corrupt payments to foreign officials had caused serious damage to American foreign relations in critical areas of the world. The House Report pointed out that revelations of corporate bribery "shook the Government of Japan to its political foundations and gave opponents of close ties between the United States and Japan an effective weapon with which to drive a wedge between the two nations." 1/ In addition, the House Report observed that, in Italy, alleged payments to officials of the Italian Government "eroded public support for that Government and jeopardized U.S. foreign policy, not only with respect to Italy and the Mediterranean area, but with respect to the entire NATO alliance as well." 2/ The Senate Report voiced similar concerns and noted, "The image of American democracy abroad has been tarnished." 3/

The Congress also determined that bribery of foreign officials could seriously injure the long-range interests of American business. For example, the Senate Report on the FCPA concluded that "[c]orporate bribery of foreign officials * * * affects the very stability of overseas business," and is a practice that "is fundamentally destructive" of the basic tenet of our free market system -- the principle that competition for sales "should take place on the basis of price, quality and service." 4/ The House Report expressed similar concerns. Moreover, with respect to the direct costs that American businesses might incur as a result of bribery of foreign officials, the House Report added that the exposure of corporate bribery can damage a company's image, lead to costly lawsuits, cause the cancellation of contracts and result in the expropriation of valuable overseas assets. 5/ These costs are often overlooked in discussions of the bribery prohibitions.

1/ H.R. Rep. 95-640, 95th Cong., 1st Sess. 5 (1977).

2/ Id.

3/ See S. Rep. No. 95-114, 95th Cong., 1st Sess. 3 (1977).

4/ H.R. Rep. No. 95-640, supra at 4-5.

5/ Id.

B. Reasons for Enactment of the Accounting Provisions

In the context of the reasons for enactment of the accounting provisions, the draft merely indicates that the Commission "found that millions of dollars were inaccurately recorded in corporate books and records." It does not adequately reflect why the Commission and the Congress thought it was important to enact the accounting provisions.

It should be noted at the outset that the accounting provisions were intended largely as a self-regulatory measure. The Commission's Report on Questionable and Illegal Corporate Payments and Practices, which recommended the enactment of the accounting provisions to the Congress, reflects that the primary thrust of the Commission's actions in the area of questionable payments was "to restore the efficacy of the system of corporate accountability and to encourage the boards of directors to exercise their authority to deal with the issue." 6/

In detailing the Commission's findings with respect to the corporate payments cases that had come to its attention during the previous three years, the Commission's Report concluded:

> The almost universal characteristic of the cases reviewed to date by the Commission has been the apparent frustration of our system of corporate accountability which has been designed to assure that there is proper accounting of the use of corporate funds and that documents filed with the Commission and circulated to shareholders do not omit or misrepresent material facts. 7/

The "most devastating disclosure" resulting from the Commission's inquiry was the extent to which some companies had falsified their books and records, in many cases with the knowledge of top management. 8/ The Commission's Report also found a number of other disturbing practices associated with the making of questionable or illegal payments, including the "accumulation of funds outside the normal channels of financial accountability, placed at the discretion of one or a very small number of corporate executives not required to account for expenditures from the fund," the use of "non-functional subsidiaries and secret bank accounts" and the use of various methods of "laundering" or otherwise disguising the source

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6/ Senate Committee on Banking, Housing and Urban Affairs, Report of the Securities and Exchange Commission on Questionable and Illegal Corporate Payments and Practices, 95th Cong., 1st Sess. (1976) (hereinafter referred to as "the Commission's Report") at b.

7/ Id. at a (emphasis added).

8/ Id. at 58 and a.

of funds used for such payments or the purposes for which they were disbursed. 9/

In brief, the Commission reported that its experience in uncovering questionable and illegal payments had revealed a breakdown in the system of corporate accountability, which was a matter of concern irrespective of any bribery or questionable payments. 10/ As the Commission's Report pointed out:

> A fundamental tenet of the recordkeeping system of American companies is the notion of corporate accountability. It seems clear that investors are entitled to rely on the implicit representations that corporations will account for their funds properly and will not "launder" or otherwise channel funds out of or omit to include such funds in the accounting system so that there are no checks possible on how much of the corporation's funds are being expended or whether in fact those funds are expended in the manner management later claims. 11/

The Commission was concerned because questionable and illegal corporate payments, and the related practices associated with such payments, had "cast doubt on the integrity and reliability of the corporate books and records which are the very foundation of the disclosure system established by the federal securities laws." 12/ Accordingly, the Report stated:

> Whatever their origin, the Commission regards defects in the system of corporate accountability to be matters of serious concern. Implicit in the requirement to file accurate financial statements is the requirement that they be based on adequate and truthful books and records. The integrity of corporate books and records is essential to the entire reporting system administered by the Commission. 13/

While it is true that the accounting provisions "were intended to operate in tandem with" the bribery prohibitions of the FCPA to deter corporate bribery, the deterrence of such bribery was intended to be a result of a

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9/ Id. at 23-24.

10/ Id. at b.

11/ Id. at 58.

12/ Id. at 49-50.

13/ Id.

more effective system of corporate accountability, rather than the sole purpose that those provisions were intended to achieve. Statements (see page 2 of the draft report) to the effect that accounting provisions are "far-reaching," much broader" than the title of the FCPA suggests, and neither "limited to companies doing business abroad, nor * * * restricted to corrupt payments" appear to overlook the concern for improving corporate accountability.

Without the perspective provided by the analysis set forth in the Commission's report and in the legislative history of the FCPA, a reader unfamiliar with those sources might draw the erroneous conclusion that perhaps the Congress failed to understand the implications of what it was doing when it adopted provisions prescribing "internal accounting control objectives and recordkeeping requirements that go beyond corrupt foreign payments" (id.) Nor would such a reader have a sufficient basis for understanding why the statute was enacted and the goals that it is intended to achieve.

C. Undue Emphasis Upon Potential Criminal Liability

Chapter I also evidences a preoccuption with the fact that a violation of the FCPA could, in an appropriate case, result in a criminal prosecution. For example, the draft report states (page 3) that criminal penalties for violation of the accounting provisions would result in "a fine of up to $10,000 and imprisonment up to 5 years" (emphasis added). The report then adds (p. 3) that, "[d]epending on the circumstances, a violation could also result in a SEC civil enforcement action" seeking equitable relief (emphasis added). This suggests that criminal prosecution will be the principal method of enforcement of the accounting provisions when, in fact, it is the civil injunctive action that is the principal mode of enforcement. A criminal prosecution would be recommended to the Justice Department for violation of the accounting provisions only in the most serious and egregious cases. In addition, even if a prosecution should be commenced by the Department, the question of penalties would depend upon the outcome of a trial (if a "not guilty" plea is entered) and the determination by a federal district judge as to what penalty is appropriate, after the trial, and after a finding of a "willful" violation.

The draft report makes no mention of the fact that the Commission has brought six injunctive actions to enforce the accounting provisions in the three years since the FCPA was enacted. In contrast, no criminal cases have been recommended to the Justice Department to enforce those provisions. Nor does the draft report describe the circumstances that caused the Commission to seek equitable relief in the courts. In each case, the violations were of a serious nature and we are not aware of any criticism that those actions were in any way inappropriate.

Moreover, even in the context of civil injunctive actions, many of the fears reflected in the draft report with respect to the possible enforcement of the accounting provisions are misplaced. The Commission's Chairman, Harold M. Williams recently gave an address to a meeting of the American Institute of Certified Public Accountants ("AICPA"), which was entitled "The

Accounting Provisions of the Foreign Corrupt Practices Act: An Analysis." 14/ In that address, he stated the Commission's policy — with the concurrence of all of the other Commissioners — concerning Commission actions to enforce the accounting provisions. After pointing out that the Commission has considered the commencement of enforcement actions "prudently and with common sense," he noted that

> "the Commission has not sought out violations of the accounting provisions for their own sake; indeed, we have not chosen to bring a single case under these provisions that did not also involve other violations of law. The Commission, instead, places its greatest emphasis on encouraging an environment in which the private sector can meet its responsibilities in complying with the Act meaningfully and creatively."

Toward the end of the address, Chairman Williams indicated that the Commission's efforts have been directed toward encouraging

> "public companies to develop innovative records and control systems, to modify and improve them as circumstances change, and to correct recordkeeping errors when they occur without a chilling fear of penalty or inference that a violation of the Act is involved."

Chairman Williams also pointed out that the principal objective of the accounting provisions is to prevent knowing or reckless conduct; and he alluded to the fact that the courts must find that there is a reasonable likelihood that a defendant will engage in violative conduct in the future before injunctive relief is appropriate:

> "[W]e would expect that the courts will issue injunctions only when there is a reasonable likelihood that the misconduct would be repeated. In the context of the accounting provisions, that showing is not likely to be possible when the conduct in question is inadvertent."

In the context of civil injunctive actions, but not criminal prosecutions, Chairman Williams also declared, as a statement of the Commission's policy, that "[i]f 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." Like inadvertent conduct, such unauthorized violations by low-level employees would not generally support a showing that the issuer gua issuer will repeat the conduct in the future. An injunction against the issuer would therefore be inappropriate.

14/ The address was delivered on January 13, 1981, in Washington, D.C.

The draft report also gives undue emphasis to potential criminal liability under the bribery provisions. It notes that the "potential penalties for violating the antibribery provisions are severe" and further notes that, in addition to the penalties described above in the context of the accounting provisions, the FCPA provides that "SEC registrants and domestic concerns * * * can be fined up to 1 million." The draft report fails to mention that the Commission has commenced only one injunctive action to enforce the bribery prohibitions in the three years since the statute was enacted. In addition, the Justice Department has brought one civil injunctive action, and one action that had both civil and criminal aspects, to enforce the bribery prohibitions. 15/ Thus, contrary to the impression suggested by the draft report, a criminal prosecution does not automatically result whenever the Commission or the Justice Department discovers a violation of the bribery prohibitions.

D. Use of Anonymous Comments That Are Not Part of the Empirical Data Base Acquired in Response to the GAO's Questionnaire and Limited Supplemental Survey

The draft report appears to be based, in large measure, upon information derived from sources other than the responses to the questionnaire and the GAO's limited supplemental survey of leading companies in the aircraft and construction industries. To the extent the data received in response to the questionnaire is based on accepted survey and statistical sampling techniques, together with a audit of 27 of the respondents to assess the credibility of their responses, the GAO Report provides empirical data that has a credible basis. Unfortunately, this empirical data is mixed together with anonymous comments received from public accounting firms, professional accounting an auditing organizations, professional legal associations, "cognizant business and public interest groups" and certain government officials that do not have responsibility for administering or enforcing the FCPA. Because these comments are often stated in conclusory terms, it cannot always be determined what the reasons for those comments are, whether those reasons have merit or whether they may be based upon faulty premises. Moreover, the draft report tends to include negative comments from such sources without any apparent effort on the GAO's part to evaluate whether the reasons have merit, or whether the statements repeated in the draft are credible.

Moreover, most of these criticisms are anonymous. Although we recognize that some persons may be reluctant to speak about corporate bribery in a public manner as a result of the "sensitivity" of the subject (see pages 16 and 19 of the draft report), this does not alter the fact that anonymous comments are neither as credible nor as probative as the empirical data the GAO received in response to its questionnaire. For example, Representative Bob Eckhardt, one of the principal sponsors of the FCPA, emphasized the importance of having critics of the FCPA speak with candor and a willingness to make their position public and open, so that the Congress can make its

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15/ See Securities Exchange Act Release No. 17099 (Aug. 28, 1980); 45 Fed. Reg. 59001 (Sept. 5, 1980).

own evaluation of the facts. 16/ During a hearing before the Subcommittee on Oversight and Investigations of the House Committee on Interstate and Foreign Commerce, the Chairman of the White House Task Force on Export Disincentives indicated that that group had received certain information about the impact of the FCPA from many sources, including businesses which "insisted that their company name and the details of the transaction not be revealed." 17/ Congressman Eckhardt responded:

> "I must say that ultimately the persuasiveness of the information will be reflected upon by the failure to be able to identify the source of the information * * *. That sort of thing would not be given much weight by anybody probing a factual question." 18/

Chapter 2: THE ACT'S IMPACT ON CORPORATE ACTIVITIES

Although Chapter 2 of the draft report reflects that the FCPA has had a substantial impact on corporate conduct, the draft does not adequately emphasize the extent to which the FCPA has been a positive force. In addition, the chapter emphasizes perceptions that the cost of complying with the accounting provisions exceed the benefits and that the Act has had an adverse impact upon U.S. overseas business, despite the survey data which indicate that these concerns may either be exaggerated or a matter of concern to a relatively small proportion of the companies surveyed. Under these circumstances, we have set forth our own analysis of the survey data below in order to assist the GAO in understanding our position.

A. The Accounting Provisions

The data compiled in response to the GAO questionaire indicates that the accounting provisions have been a success in promoting the objectives that the Congress sought to achieve in enacting those provisions. For example, 95.7% of the respondents reviewed their audit and internal accounting control functions or compared them with the requirements of the FCPA, after the statute was enacted. Moreover, 80.7% of these respondents made changes as a result of that review. 19/ These findings seem to be particu-

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16/ Hearing before the Subcommittee on Oversight and Investigations of the House Committee on Interstate and Foreign Commerce, Serial No. 96-56, 96th Cong., 1st Sess. (1979) at 21.

17/ Id. at 23.

18/ Id. at 24.

19/ A total of 78.6% of the respondents reported that they had increased the amount of their internal accounting control documentation to a "moderate," "great" or "very great extent." In addition, 52.5% increased routine testing of their internal accounting control systems to a "moderate," "great" or "very great extent."

larly significant in view of the fact that 64.9% of the respondents had already revised or increased their audit and internal accounting control functions, or made related changes, in the four-year period prior to enactment of the FCPA. Taken together, the findings seem to indicate that four out of five issuers found it necessary to make improvements in their audit and internal accounting control functions in order to provide reasonable assurances that the statutory objectives are met.

Similar findings were made with respect to the effect that the FCPA has had in the area of corporate codes of conduct. Nearly all of the respondents — 98% -- reviewed their codes of conduct or compared them with the requirements of the FCPA. In addition, 63.4% of the respondents made changes or revisions as a result of that review. These figures seem particularly noteworthy in view of the survey data reflecting that 50% of the respondents had already made changes in their codes of conduct in the four-year period prior to enactment of the FCPA, and 25% did not find further changes to be necessary after the law became effective. Moreover, the changes that were made since the enactment of the FCPA were characterized by the respondents as "important" rather than "minor" in the following areas: questionable or improper foreign payments (40.5%); misuse or mismanagement of cash pools or funds (45.2%); failure to record transactions (53.6%); failure to secure proper authorization for transactions (50%); failure to assure the security of company assets (47.1%); failure to assure proper utilization of company assets (46.3%); and the making of false entries on company books and records (47.5%). The fact that such large percentages of the responding companies found it necessary or desirable to make "important" changes in these areas provides strong evidence that the accounting provisions have caused issuers to address possible serious deficiencies in their systems of internal accounting controls.

On the other hand, despite the "reasonable assurances" limitation in the internal accounting controls requirement, which is designed to make clear that the costs of internal accounting control are not required to exceed the benefits thereof, the survey reflects that slightly more than half of the respondents (56.4%) believed the costs of compliance with the accounting provisions had exceeded the resulting benefits. The remainder (43.6%), stated that the costs were not excessive. It should be noted, however, that of the respondents indicating that the costs of compliance did exceed the benefits, 27.3% (15.4% of the universe of respondents) viewed the perceived excess costs as marginal (in the range of 10% or less). Thus, 59% of the respondents reported that there were either no excessive costs or an excess of 10% or less. Approximately 28% of the respondents estimated excess costs at between 11% and 35%, which the GAO questionnaire characterized as less than a "moderate" amount. In summary, approximately 87% viewed the excess costs as less than a "moderate" amount (excess costs of 36 to 65%), while only 5% stated that excess costs were "great" or "very great" (excess of more than 66%).

The draft report notes that "[c]ost-benefit analysis * * * [implicit in the "reasonable assurances" limitation] is not an exact science" and suggests that the perception of excessive costs "may be due to the subjectivity inherent in determining what constitutes compliance with the Act and to the

limitations in performing a cost-benefit analysis." The draft report then refers to a recent study prepared by the Financial Executives Research Foundation, which found that an objective measure can rarely be made of costs and benefits. As a result, the draft concludes that some corporate officials may have expended more on internal accounting controls than they would normally have spent for business purposes in order to minimize the risk of noncompliance.

Although it may be true that some corporate officials did expend more than was cost-effective in the initial period of uncertainty after the enactment of the statute, the GAO's data indicates that this was not a serious problem for three out of five of the respondents surveyed. Moreover, it has now been three years since the FCPA was enacted. During that period numerous articles have been written concerning the subject of internal accounting controls and guides have been prepared by accounting firms to assist reporting companies in complying with the terms of the accounting provisions. The Commission has also provided guidance as to how the accounting provisions should be interpreted and implemented 20/ and has adopted rules which prohibit the falsification of corporate books and records and the making of false or misleading statements to an accountant in the course of an audit or the preparation of a document for filing with the Commission. 21/

In addition, companies have had three years of experience in making the judgments and estimates contemplated by the Act. Given the state of the art with respect to the making of cost-benefit judgments concerning internal accounting controls at the time the FCPA was enacted, and the fact that a certain degree of confusion was to be anticipated in implementing a new law, it is not surprising that there may have been some costs that have proved to be excessive. It should also be pointed out, however, that a large portion of the costs incurred may be in the nature of one-time start-up costs, such as those that many issuers incurred in conducting comprehensive reviews of their internal accounting control systems and taking corrective action with respect to the deficiencies that they discovered. In addition, it should be noted that improved systems of internal accounting controls should serve to reduce the costs of the annual audit of the financial statements of issuers, because the auditors will be able to place greater reliance on such systems than they did prior to enactment of the FCPA.

Moreover, it should be apparent, after three years of experience, that the Commission will not, as some have feared, use the accounting provisions as a basis for taking enforcement action against public companies, no matter

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20/ See Securities Exchange Act Release No. 15772 (Apr. 30, 1979); 44 Fed. Reg. 26702 (May 4, 1979) and Securities Exchange Act Release No. 16877 (Jan. 9, 1980); 45 Fed. Reg. 40134 (June 13, 1980).

21/ See Securities Exchange Act Release No. 15570 (Feb. 15, 1979); 44 Fed. Reg. 10964 (Feb. 23, 1979). These rules are not discussed in the draft report.

how trivial or insignificant an infraction might be. As noted above, only six injunctive actions have been filed, and one administrative proceeding instituted, in the three years since the FCPA was enacted.

Under these circumstances, the fact that only two out of five respondents reported more than a marginal excess of costs, is a strong indication that the "reasonable assurances" standard is not as ambiguous and confusing as some have suggested. In fact, an argument could be made that the additional experience has either eliminated, or will largely eliminate, the problem experienced by those respondents who did report excess costs of more than a marginal amount at some point in the last three years.

Even if there may be some excess costs on the basis of the calculation performed by an issuer for its own purposes, it should be recognized that the "benefits" to the nation in the form of more reliable disclosure to investors, improved accountability, greater confidence in the capital market system and the deterrence of bribery and other improper conduct are important considerations. To the extent "excess costs" may be of a marginal nature, these "benefits" might be viewed by the Congress as justifying some degree of "excess costs".

B. The Bribery Prohibitions

The GAO's draft report also provides empirical evidence that the bribery provisions have been a striking success. For example, 76.5% of the respondents stated that the Act "has" or "probably has" been effective in reducing questionable corporate payments abroad. Only 5% asserted that the Act "has not," or "has probably not," been effective.

Although there have been widespread assertions that the FCPA has caused American companies to lose business, the GAO report notes that these claims "are not supported by hard verifiable data." The GAO's survey data (but not its report) indicates that, while there has been some lost business, this has been a much less serious problem than many have assumed. Indeed, less than one percent reported any serious loss of business. Nearly 68% of the respondents that engage in overseas business reported that the bribery prohibitions have had little or no effect on such business. In addition, if those reporting only a marginal decrease in business are included, the GAO survey indicates that 87.5% of the respondents either experienced no loss in business, or only a minor decrease in business. Inexplicably, this point is not made in the draft report. In contrast, only 12% of the respondents reported a decrease of business that could be characterized as "moderate" and less than 1% of the respondents indicated that they had suffered a "great decrease" in business. 22/

22/ Since the draft report does not reflect the number of respondents that did have foreign business, we are unable to determine the number of these respondents as compared with the universe of 185 respondents to the questionnaire. For example, the .6% experiencing a "great" decrease in business could mean that anywhere from one to eleven companies experienced such a decrease.

These figures seem particularly significant in view of the fact that the GAO questionnaire merely asked for "your opinion, to what extent, if at all" the FCPA has "affected your total overseas business," an approach that might be expected to result in an exaggeration of the amount of business lost. In short, the data appears to provide a strong confirmation of the view, expressed by proponents of the FCPA prior to its enactment, that corporate bribery is generally unnecessary in order to obtain, retain or direct business to U.S. companies.

Another finding that appears to be particularly significant concerns the clarity of the bribery prohibitions. These provisions have been criticized in many quarters as ambiguous and confusing, and these criticisms are repeated in the draft report despite survey data that suggests an opposite conclusion. For example, a total of 79.5% of the respondents indicated that the clarity of the bribery prohibitions was either "adequate" or "more than adequate." In contrast, only 8.8% expressed the view that the clarity of the bribery prohibitions was either "inadequate" or "very inadequate." 23/

Chapter 3: CONTROVERSY AND CONFUSION OVER THE ACT'S ACCOUNTING PROVISIONS

A. Introduction

The draft report asserts that the "accounting provisions have been steeped in controversy and confusion" and states that "[t]he business community has criticized the provisions as being too vague to provide guidance on how sophisticated an accounting system needs to be to constitute compliance" (page 21). 24/

23/ The remainder, about 11.7%, characterized the bribery prohibitions as of "marginal clarity."

Other responses to the same question reflect a greater degree of concern about certain aspects of the bribery prohibitions, but these also represent a minority view. Only 19.3% described the provision concerning facilitating payments as "inadequate" or "very inadequate," while 58.5% reported that the same provisions were "adequate" or "more than adequate." Similarly, only 23.5% stated that the clarity of the Act concerning questionable payments by subsidiaries was either "inadequate" or "very inadequate," but 57.8% stated that the provisions were either "adequate" or "more than adequate." The greatest difficulty was evident with respect to a company's responsibility for the actions of foreign agents, but even in this area, only 36.9% believed the bribery provisions were "inadequate" or "very inadequate," while 45.3% indicated that the same provisions were "adequate" or "more than adequate."

24/ The draft report overspeaks when it refers to the "business community". We suggest that the report be qualified to reflect that some, rather than all, members of the business community have expressed such sentiments.

It alleges that "[t]here is much confusion over terms such as "reasonable assurances" and "in reasonable detail" and that the accounting provisions must be given "low marks on clarity" (page 23). In addition, it asserts that the "accounting provisions are "inherently subjective * * *" (page 21) and lack "objective criteria for determining whether a recordkeeping or internal control deficiency is a violation" (page 23). Finally, the draft report states that, absent a materiality standard, "compliance with the provisions is perceived by the business community as being too costly" (page 21).

Unfortunately, the GAO draft repeats these criticisms, as if they should be accepted at face value, without pointing out that the criticisms have often been based upon faulty premises. Although critics are entitled to their own opinions, the Congress should be made aware that many critics have tended to: (a) overlook the fact that the accounting provisions are intended to promote improved accountability for the use and disposition of corporate assets, as well as to assure that reporting companies will be able to prepare reliable financial statements in accordance with generally accepted accounting principles; 25/ (b) mistakenly assume that, in the absence of a materiality standard, there are no standards to guide companies in complying with the Act and no limitations on potential liability, and, thus (c) overlook the fact that the "in reasonable detail" and "reasonable assurances" standards, although new and unfamiliar, serve both to provide guidance as to what must be done to comply with the Act and to limit liability.

In addition to its failure to present analysis of which criticisms have merit and which do not, the draft does not present analysis of the meaning and function of the "in reasonable detail" and "reasonable assurances" standards so that the Congress will have a basis for understanding these terms and for assessing the degree of merit which criticisms of those standards may have and whether proposed changes, such as the inclusion of a "materiality" standard, would be consistent with the purposes of the Act. The draft report also fails to delve below the surface of the criticisms and point out that the underlying concern is not really "what constitutes compliance," as the draft report suggests, but rather an understandable desire, with which we have some sympathy, for assurances that entities and individuals will not be held liable for inadvertent or insignificant infractions, or merely for proceeding in accordance with a judgment within reason with which the Commission may subsequently differ.

We recognize that there are certain problems in interpreting the FCPA. These problems require careful and judicious consideration. The GAO's report will probably play a key role in the deliberations of the Congress concerning the FCPA. We are concerned, however, that frequent repetition of

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25/ An illustration of this overlooked point is the ABA Guide to the accounting provisions which is often referred to in the draft report. The draft report does not even mention this fundamental shortcoming in the ABA Guide's reasoning and analysis.

criticisms of the accounting provisions, without any corresponding evaluation of the merits and shortcomings of such criticisms, may be misleading by not providing a sufficient basis for the Congress to separate those criticisms that have merit from those that do not. In addition, we are concerned that unless the present Congress is fully apprised of the reasons why the statute was enacted in its present form, and what kinds of changes are consistent with the multiple purposes of the statute and what are not, possible amendments to the accounting provisions may be perceived by the business community as more confusing and burdensome than the existing law.

The issue of materiality provides one illustration of this important point. As the draft report notes (page 21), some members of the business community perceive compliance with the accounting provisions as being too costly in the absence of a materiality standard and bills have been introduced in the Congress that would add a "materiality" standard. But the GAO's draft report also recognizes (pages 31-34) that such a change could "establish a benchmark below which questionable corporate practices may be exempt" (page 33) and "could weaken the present intent of the accounting provisions to enhance corporate accountability over assets" -- an aspect of the Act that many critics have overlooked. This is the kind of useful analysis and balance that is needed if the Congress is to be able to sort out which proposed changes in the law may be appropriate, and which are not consistent with the purposes that an earlier Congress sought to achieve in adopting the accounting provisions.

B. The Focus on What Constitutes Compliance Reflects a Fundamental Misunderstanding of the Law

As noted above, the draft report asserts that "[t]he business community has criticized the accounting provisions as being "too vague to provide guidance on how sophisticated an accounting system needs to be to constitute compliance" (page 21). The draft also states that "critics emphasize that * * * [the Act] lacks objective criteria for determining whether a recordkeeping or internal control deficiency is a violation" (page 23). The GAO apparently agrees with these criticisms (see pages 21 and 23) and independently asserts that the "accounting provisions are inherently subjective and can be interpreted differently" (page 21; see pages 26-27 and 35).

The discussion in the draft report does not consider the fact that the "in reasonable detail" and "reasonable assurances" standards, like the "materiality" and "negligence" standards applicable in other areas of the law, are considered "objective" standards. These standards are considered "objective" in the law because a court faced with determining whether a violation has occurred must look, not to the subjective state of mind of an individual defendant, but to an objective standard -- whether the defendant failed to act as a reasonable and prudent person would have acted under the same or similar circumstances. In addition, each of these standards necessarily requires that any finding of violation be based upon an assessment of all of the relevant facts and circumstances — after conduct at issue has occurred — to determine if it measures up to that standard.

It appears that many critics of the accounting provisions erroneously view this situation as an anomaly and fail to understand that such application of general standards of law to factual situations is not unusual in the law. In addition, such persons tend to overlook an important distinction. To the extent that they are concerned about potential liability based upon such an after-the-fact assessment of all relevant circumstances, the source of the lack of certainty they perceive is not necessarily in the language of the accounting provisions; rather it lies in the fundamental fact — which is not limited to the FCPA — that general standards of law must be applied to particular sets of facts and circumstances. As a result, there will always be a degree of uncertainty as to potential liability in this area, just as there is in other areas of the law.

The question of "what constitutes compliance" is usually asked with respect to rather narrow and technical provisions which require specific actions to be performed. For example, if a statute requires a company to file an annual report no later than April 15, compliance is effected by filing the report on or before that date. In contrast, "what constitutes compliance" with the internal accounting controls requirement will necessarily depend on an evaluation of all of the facts and circumstances relevant to each reporting company. As the Senate Report states with respect to the internal accounting controls requirement:

> "The size of the business, diversity of operations, degree of centralization of financial and operating management, amount of contact by top management with day-to-day operations, and numerous other circumstances are factors which management must consider in establishing and maintaining an internal accounting controls system." 26/

Although the Commission is sensitive to the concerns of members of the business community who must implement the law, and agrees that there should be workable standards to guide them in their efforts, it is impossible, under these circumstances, for the Commission to satisfy the desire of some for "precise" and "definite" guidance (see pages 32-33). The question of "what constitutes compliance" can only be answered with respect to each individual company subject to the Act. From this perspective, it would clearly be impractical to tell each issuer "what constitutes compliance."

Alternatively, some members of the business community have expressed a desire for "guidance" in the form of a checklist of actions that could be taken to comply with the internal accounting controls requirement. Such a checklist would be of limited value, however, because it would have to be comprehensive in order to cover every possible action that might be necessary. Even aside from the difficulty of drafting such a comprehensive list, many actions would inevitably be listed that would be appropriate for some issuers, but inappropriate for other issuers facing different situations. Moreover, an issuer would not necessarily be required to take any action on

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26/ S. Rep. No. 95-114, supra at 8.

the list in order to comply with the Act. Accordingly, an issuer that viewed such a checklist as a guide to "what constitutes compliance" might incur excess costs by taking actions that are neither appropriate under facts and circumstances of that issuer, nor required by the "reasonable assurances" standard. 27/

The mere fact that prescribed actions were taken would not necessarily result in compliance; one would also have to consider how an action was carried out in order to assure that it reflects the kind of action that would be expected of a reasonable and prudent corporate official and does not in fact elevate form over substance. Thus, in the final analysis, corporate officials will still have to exercise discretion and judgment as to what actions are appropriate with respect to their company, no matter what "guidance" may be provided as to compliance with the accounting provisions.

Another important consideration, which many critics of the FCPA fail to understand, is that the accounting provisions are, in a very real sense, intended to be a self-regulatory measure. The Congress anticipated that the Commission would leave the initial judgments as to what actions are appropriate to the management of reporting companies. The Commission is expected to intervene only in those limited instances in which it has reason to believe that a company's management has deviated from the norm of reasonable and prudent conduct. In this context, the Chairman of the Commission, Harold M. Williams, has stated his view that the accounting provisions are designed "to reduce the need to invoke the processes of the federal bureaucracy by making clear that primary responsibility for the integrity of corporate controls rests on management and the board of directors." 28/ He added that the accounting provisions, in large measure, recite "a business truism":

> "Obviously, it would be impossible to conduct an enterprise of any size without keeping records -- accurate records -- and without making provisions to ensure that assets are not misappropriated and that the venture operates in accordance with management's instructions rather than each employee's individual whims." 29/

He placed the accounting provisions in perspective, noting that they require "business ventures funded by the investing public" to install record-

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27/ The reasonable assurances standard is discussed infra.

28/ "Implementation of the Foreign Corrupt Practices Act: An Intersection of Law and Management," an address to the Section of Business, Banking and Corporation Law of the American Bar Association, Dallas, Texas (August 14, 1979).

29/ Id.

keeping and control procedures which would appear necessary "as a matter of effective management * * *." 30/

As discussed more fully below with respect to the "reasonable assurances" standard, the statute now provides corporate officials with broad discretion to decide how their companies will comply with the Act and measures the exercise of that discretion with reference to what a reasonable and prudent person would do under the same or similar circumstances. But it is this very fact that makes it impossible for the Commission to answer the question of "what constitutes compliance" in precise and detailed terms. And the alternative is to take those decisions away from corporate officials through Commission prescriptions of how each company should conduct its internal affairs -- an approach that we believe is unwise, unworkable and inconsistent with the purposes of the Act.

C. The "in reasonable detail" and "reasonable assurances" standards

Although the draft report emphasizes the alleged "confusion and controversy" concerning the accounting provisions, it tends to blur the distinctions between the recordkeeping requirement and the internal accounting controls provision (see pages 22 and 31). If the draft report is to be useful to Congress, or persons who are unfamiliar with the FCPA or the reasons why the accounting provisions were enacted, it is important that the report reflect why the two provisions were enacted in their present form. As presently drafted, the report repeatedly states criticisms that the "in reasonable detail" and "reasonable assurances" standards are confusing and ambiguous, but does not attempt to explain what they are intended to accomplish and why they are different. Nor does the draft point out that the relevant policy considerations are very different in evaluating possible changes with respect to these two provisions.

1. "In reasonable detail"

In order to understand the "in reasonable detail" standard, it must first be understood that it deals with the recording of individual corporate transactions and dispositions of assets. The recording requirement is addressed to the issuer and the employees of the issuer who are responsible for entering transactions on the books and records of the company. In this context, although there are concerns of substance with respect to liability for a failure to comply, claims of confusion as to "what constitutes compliance" appear to have little merit.

The recordkeeping requirement requires issuers 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" (emphasis added). With respect to claims of a lack of "clarity," the statute, in essence merely requires that transactions be accurately recorded. As

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30/ Id.

the authoritative auditing literature points out, transactions should be recorded "at the amounts and in the accounting periods in which they were executed and be classified in appropriate accounts." 31/

At the time the accounting provisions were being considered in the Congress, some members of the business community contended that a standard of accuracy in recording transactions would require an unrealistic degree of precision. In response to these concerns, the Conference Committee added the "in reasonable detail" qualification to make clear that transactions may be recorded "in conformity with accepted methods of recording economic events * * *." 32/

Accordingly, the general rule is that the transaction must be recorded, as Section 320.38 of S.A.S. I states, "at the amount at which it occurs." It is only if the company or its accountants have an "accepted" basis for employing some method of recording a transaction that permits it to be recorded at an amount other than the precise amount at which it occurred, that there may be a question as to how it should be recorded. 33/ For these reasons, the assertion of one accounting firm that "there are no standards to assist in determining compliance with the accounting provisions" is wholly without foundation, as is the statement that "management's view of how accurate their records need to be may differ significantly from the degree of accuracy the Act may require" (see page 24). In short, if a transaction is effected at a particular amount, the presumption is that it should be recorded at that figure, rather than at a greater or smaller amount.

Indeed, the problem with the recordkeeping requirement may be that it is too clear. On its face, the recordkeeping provision appears to make issuers liable for inaccuracies, regardless of whether they are the result of an inadvertent transposition of two numbers, involve an insignificant amount, or could not reasonably have been prevented by the issuer and senior corporate officials. Therefore, criticisms of the recordkeeping provision have tended to take the position that there should be some mimimum threshold amount, below which a transaction could permissibly be recorded at an amount other than that at which it occurs, whether or not there is any basis for doing so in the accounting literature. Although this view has been voiced by critics of the Act, presumably in an effort to limit possible liability for inadvertent or insignificant errors, it is important to understand the nature of the competing policy considerations that are implicit in such an approach. On one hand, the legislative history reflects the de-

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31/ Statement on Auditing Standards No. 1, Section 320.38.

32/ H. R. Rep. No. 95-831, 95th Cong., 1st Sess. (1977) at 10.

33/ For example, to the extent a de minimus exemption is recognized and "accepted" in the context of recording economic events, although not in absolute, quantitative terms, it would be permissible under the recordkeeping requirement.

sire of the Congress to emphasize the fundamental principle that all transactions and dispositions of assets should be accurately accounted for in a company's books and records -- a principle that the statute refers to as the maintenance of accountability for assets. On the other hand, there is undoubtedly merit in the proposition that an inadvertent or insignificant error does not require the government to "roll out the federal artillery" in order to redress the problem. The critical question is how to reconcile the latter proposition with the principle that all corporate transactions should be accurately recorded in the company's books and records without, at the same time, condoning the falsification of corporate books and records or other improper practices.

In this context, the draft report recognizes, correctly in our view, that the use of a traditional materiality standard as a quantitative threshold would establish "a benchmark below which questionable practices [with respect to the recording of transactions] may be exempt" and "could weaken the present intent of the accounting provisions to enhance corporate accountability over assets" (page 34). 34/ However, the draft report then recommends that the Commission "develop" an "explicit standard" (see page 35) that will prescribe "lower quantitative thresholds" than the traditional standard of materiality. Except for one rather brief statement (see page 33), the draft report fails to point out that a quantitative threshold suggests that persons may falsify corporate records, as long as it involves an amount below that threshold figure. Nor does it contain any discussion as to how the concept of falsification below a threshold amount might be reconciled with the goal of maintaining accountability for assets. 35/

As we have noted, the real concern in this area is the fear that inadvertent or insignificant infractions will lead to a finding that companies

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34/ Some have suggested that a "materiality" standard be used as a quantitative threshold, but these persons have overlooked the fact that "materiality" is a standard for limiting liability for inadequate disclosure to investors and is not a standard for deciding the degree of precision necessary to record a transaction accurately. If materiality was the standard, and a transaction was not "material" to investors — i.e., one that a reasonable investor would consider important in making a decision to buy, sell or hold securities — the transaction would not have to be recorded, in any manner, in the books and records of an issuer. As the GAO draft correctly points out, this could include transactions involving large amounts of corporate assets (see page 33).

35/ In its recommendations, the GAO draft does suggest, again without discussion, that there should be "a [qualitative] requirement that all intentional falsifications by top corporate management * * *" should constitute violations "regardless of the dollar amount." This formulation would permit intentional falsifications by employees below the level of top management, as long as they were below the threshold that the draft report recommends.

or individuals have violated the recordkeeping requirement and a reluctance to trust that the Commission will exercise its prosecutorial discretion in a reasonable and prudent manner so that such a situation never arises. In our judgment, however, any response to these concerns -- whether legislative or administrative -- should begin by maintaining the integrity of the principle that transactions should be accurately recorded in the issuer's system of accounting records. This is a different issue than the question of whether issuers should be held liable for violative conduct -- an area that Chairman Williams addressed in his speech before the AICPA (see page 7, supra).

2. The "Reasonable Assurances" Standard

The internal accounting controls provision requires issuers to "devise and maintain a system of internal accounting controls sufficient to provide reasonable assurances that * * *" certain statutory objectives are met (emphasis added). This provision, in contrast to the recordkeeping requirement, is addressed primarily to the issuer and its management and to their design and maintenance of a system of internal accounting controls. In this context, corporate managers are responsible for devising and maintaining a system of internal accounting controls that provides reasonable assurances, among other things, that "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"; however, because this provision is addressed to the exercise of management's discretion in devising and maintaining a system that will achieve these objectives and the other objectives set forth in the statute, 36/ as distinguished from the entry of specific transactions in the company's books and records, the Congress employed a different standard than that contained in the recordkeeping requirement — the "reasonable assurances" standard.

The draft report correctly notes (page 22) that the reasonable assurances standard is intended to make clear that "the cost of internal control should not exceed the benefits to be derived" from such a system. The benefits "consist of reductions in the risk of failing to achieve the objectives" that the statute sets forth for a system of internal accounting controls. 37/ Unfortunately, the draft report fails to recognize that this standard provides a standard of compliance that does include a quantitative threshold. In addition, the standard also serves to limit the potential liability of the issuer and senior corporate officials for possible infractions.

36/ The other objectives include the provision of reasonable assurances that "transactions are executed in accordance with management's general or specific authorization"; that "access to assets is permitted only in accordance with * * *" such authorizations; and that "the recorded accountability for assets is compared with the existing assets at reasonable intervals and appropriate action is taken with respect to any differences."

37/ See Section 320.28 of SAS No. 1.

Contrary to the views expressed in the draft report and by some members of the business community to the effect that the reasonable assurances standard is unclear, the internal controls provision is explicit in two important respects:

(1) it requires management to "devise and maintain" a system of internal accounting controls designed to achieve the objectives set forth in the statute; and

(2) in the course of carrying out that mandate, management is permitted to delimit its obligation by determining whether existing or potential internal accounting controls will be cost-justified in terms of the benefits they may be expected to produce.

(a) Deference to Managerial Judgments

The statute and the legislation also make clear that corporate managers are accorded a broad range of discretion as to the means by which these explicit mandates are to be carried out. There are salient reasons why this is true which the draft report fails to acknowledge. First, subject to the accounting provisions are approximately 9,000 public companies which range from relatively small companies with approximately one million dollars in assets and 500 or more shareholders to the giant-sized corporations included in Fortune's list of the 1,000 largest industrial firms. In view of the vast differences in the circumstances of these issuers, it should be apparent that "what constitutes compliance" may, and should, be different for each of the companies subject to the accounting provisions. Government prescription of what each individual company must do to comply would be wholly impractical and would intrude upon management's prerogative to determine what internal accounting controls may be appropriate for their company, and whether such controls will be cost-effective.

For example, certain changes in a company's code of conduct may be appropriate for some issuers and not for others. Increased routine testing may be appropriate for some issuers, but not be needed by others. It would be unwise to require every issuer to implement such changes in response to a government prescription of "what constitutes compliance"; that would surely entail excess costs for companies that do not need such measures.

Under these circumstances, it is the Commission's position, as stated by Chairman Williams in his recent address to the AICPA, that "considerable deference properly should be afforded to the company's reasonable business judgments in this area" (emphasis in original). Chairman Williams added that "the selection and implementation of particular control procedures, so long as they are reasonable under the circumstances, remain management prerogatives and responsibilities." 38/

38/ He pointed out that this standard is not satisfied if a company's leadership, while making nominal gestures with respect to monitor-

(footnote continued)

In the Commission's view, as stated by Chairman Williams in his address to the AICPA:

> "The test of a company's control system is not whether occasional failings can occur. Those will happen in the most ideally managed company. But, an adequate system of internal controls means that, when such breaches do arise, they will be isolated rather than systemic, and they will be subject to a reasonable likelihood of being uncovered in a timely manner and then remedied promptly. Barring, of course, the participation or complicity of senior company officials in the deed, when discovery and correction expeditiously follow, no failing in the company's internal accounting system would have existed. To the contrary, routine discovery and correction would evidence its effectiveness."

(b) Cost-Benefit Judgments

There is an important consideration that is often overlooked by persons who complain that the "reasonable assurances" standard lacks clarity. Although it may be difficult, and often impossible, to make an objective determination as to the precise point at which the costs of a particular internal accounting control may exceed its anticipated benefits, the law does not require that such a precise point be determined. The law merely requires a reasonable determination that the costs would be more or less than the benefits that may be anticipated. Moreover, although precise determinations will often be impossible because of the judgments and estimates that are necessary, most cost-benefit judgments will usually fall clearly into either the "more than" or "less than" category. It is only when the relative costs and benefits are approximately equal that there may be a question as to whether a particular change would be cost-effective; but in those situations, given the difficulties in making a precise cost/benefit analysis, there is a measure of discretion accorded to management as to what actions, if any, should be taken. And, unless management exceeds bounds of a reasonable exercise of that dis-

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38/ (footnote continued from preceding page)

ing and evaluating the adequacy of the company's records and internal accounting controls systems, abdicates its responsibilities to foster integrity among those who operate the system:

> "Regardless of how technically sound an issuer's controls are, or how impressive they appear on paper, it is unlikely that control objectives will be met in the absence of a supportive environment. In the last analysis, the key to an adequate 'control environment' is an approach on the part of the board and top management which makes clear what is expected, and that conformity to these expectations will be rewarded while breaches will be punished."

cretion, there would not be a violation. That this should be the case is consistent with the intent of the Congress, noted above, that the internal accounting controls provision should be a self-regulatory measure.

Accordingly, in our view, changes are required in a system of internal accounting controls only if: (a) there is a deficiency in the system of internal accounting controls which produces a risk that transactions will be effected without proper authorization, or that transactions will not be recorded as necessary to prepare financial statements or to maintain accountability for assets, or that one of the other statutory objectives will not be met; (b) there are control procedures available which could be implemented in order to reduce the risk involved; (c) management determines that such control procedures would be cost-effective; and (d) the risk of loss is so significant in relation to the costs of the change that it would be unreasonable for a corporate official to refrain from implementing the change involved. If management makes a good faith judgment reasonable under the circumstances that the available control procedures would not be cost-effective, it is not required to adopt the change involved. In addition, even if a potential change is determined to be marginally cost-effective, or the relative costs and benefits of the change cannot be determined with precision, the Congress adopted a standard that accords a measure of discretion to corporate officials as to whether the change should be implemented.

Under these circumstances, there should be no excess costs associated with the devising and maintaining of an internal accounting control system since the Act only requires changes that are, by definition, clearly cost-effective. Moreover, because management has discretion even with respect to potential changes that are cost-effective, there should be no occasion for incurring "excess costs" as a result of a fear of noncompliance merely because management's estimate of relative costs and benefits is approximately equal, or cannot be determined with precision. 39/

D. The Issue of Materiality

The draft report notes the criticisms of some members of the business community that compliance with the internal accounting controls requirement will be too costly in the absence of a materiality standard (see page 21).

39/ One exception to this may be in the area of increased documentation. For example, the draft report reflects the belief of some corporate officials "that the increased documentation was a paper gathering exercise to serve as a defense against SEC inquiries" (page 15). However, this view overlooks the fact that the process of documentation provides a discipline to the exercise of management's discretion in addition to providing a basis for demonstrating that management determinations were reasonable in a Commission inquiry. It may be that the "benefit" inherent in the discipline was overlooked.

However, the absence of a materiality standard in the internal accounting controls requirement does not mean, as some persons apparently assume (see page 31), that a system of internal accounting controls is required to provide absolute assurances "that prohibited practices will not occur, however minor in amount." This should be apparent from the discussion set forth above. Such a system would not be cost-effective. In addition, the Congress explicitly recognized that no system of internal accounting controls is expected to be perfect. 40/ Similarly, the Commission has made clear that the provision does not require "a fail-safe accounting control system" without regard to the costs involved. 41/

The concerns expressed with respect to the "reasonable assurances" standard, like those voiced with respect to the recordkeeping requirement, ultimately reflect a concern for the liability consequences of a failure to comply. To a certain extent, these concerns reflect a lack of familiarity with the reasonable assurances standard and the fact that the "state of the art" with respect to cost-benefit analysis is undergoing change and development. They overlook the fact that the statute accords management a broad range of discretion and that persons and entities will not be held liable unless they have exceeded the bounds of that discretion.

The draft report asserts (page 27) that 70% of the respondents to the GAO questionnaire held the view that a materiality standard "is needed" to tell issuers what degree of "effort" is required to record transactions accurately and devise and maintain an adequate system of internal accounting controls. This statement is not consistent with the data the GAO received in response to the questionnaire. Question 37 asked respondents, among other things, whether the text of the accounting provisions "clearly explains what is expected from your company in order to be in compliance" with respect to the "issue of materiality" (emphasis added); it did not ask whether compliance would be unreasonable without such a standard.

Moreover, the question is confusing because it assumes that "materiality" is somehow relevant to the present text of the accounting provisions, despite the fact that the Congress intended that a materiality standard should have no place in the recordkeeping and internal accounting controls requirements. The Congress declined to incorporate a "materiality" limitation in the language of the accounting provisions and instead employed the "in reasonable detail" and "reasonable assurances" standards.

As Chairman Williams noted in his recent address concerning the Act, the Congress "was correct" in rejecting a materiality standard because "[i]nternal accounting controls are not only concerned with misconduct that is material to investors, but also with a great deal of conduct that is not."

40/ See S. Rep. No. 95-114, supra at 8.

41/ See Securities Exchange Act Release No. 15772, supra.

Chairman Williams also pointed out that

> "materiality, while appropriate as a threshold standard to determine the necessity for disclosure to investors, is totally inadequate as a standard for an internal control system. It is too narrow -- and thus too insensitive -- an index. For a particular expenditure to be material in the context of a public corporation's financial statements * * * 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 tolerated 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."

Under these circumstances, it is not surprising that 77% of the respondents gave an "inadequate" or "very inadequate" answer to the question. The statute was never intended to "explain" what is expected of issuers in terms of the materiality concept.

Similar problems exist with the assertion (page 27) that "all of the accounting officials we contacted believe that without a materiality standard it is unclear as to the effort required to comply with the Act's accounting provisions." The draft report subsequently reflects (page 31) that the "public accounting firms we contacted" made their comments in response to a Commission rule proposal -- a proposal that was subsequently withdrawn -- which would have required each issuer to issue an annual statement to shareholders concerning its system of internal accounting controls, together with an auditor's report on management's statement. Placed in the context of that rule proposal, these statements appear to reflect a concern that, "[t]he inapplicability of a materiality standard [to management's representation] creates the potential for limitless compliance costs, placing the burden on the auditors * * *." Moreover, the draft report summarizes the accountant's comments as stating, "[i]t is unrealistic for the SEC to require management to represent that reasonable assurance, without regards to materiality has been achieved" (emphasis added). These statements make clear that the accountants' comments in question are directed, not to compliance with the language of the accounting provisions, but instead to perceived problems that issuers and auditors would have in complying with the Commission's rule proposal. As a result, it appears inaccurate to state "all of the accounting officials we contacted" believe that a materiality standard "is needed" to provide guidance as to compliance with the Act.

Although the draft GAO report is correct in noting (see page 21) that the principle area of controversy has been over "whether the provisions

contain a materiality standard" (emphasis added), it fails to appreciate that there has been a persistent theme among critics that the accounting provisions could not mean what the statute says because there is no materiality standard, and that, as a result, those provisions should be interpreted as if the Congress did include such a standard. On the other hand, although the Congress explicitly rejected the inclusion of a materiality standard in the present law, it is plain that the critics generally agree that the accounting provisions should contain such a standard.

We recognize, as noted above, that the recordkeeping requirement, on its face, makes an issuer responsible for any infraction of the standard of accuracy, regardless of whether the amount involved is very low, or whether the infraction resulted from an inadvertent error that the issuer could not have prevented. Similarly, with respect to the internal accounting controls requirement, the draft report reflects that critics are concerned (see page 15) with the fact that cost-benefit analysis "is not a precise science," that "[r]easonable individuals with good judgment and intentions can differ in their opinions" and that a mere "difference in opinion * * * with the SEC" could render a company vulnerable to enforcement action. These expressions of concern must be viewed, however, in light of the fact that it is unlikely that the Commission would take enforcement action under such circumstances, and that none of the Commission's past enforcement actions have involved such circumstances. These concerns should also be considered in light of the Commission's enforcement policies, as stated in Chairman Williams' address to the AICPA.

E. The GAO Recommendation Concerning the Accounting Provisions

The GAO draft recommends that the Commission, "with input from Justice, the corporate community and the accounting profession, develop an explicit standard or standards * * * which clearly tells companies the degree of precision needed to comply with the Act's accounting provisions (page 35). The report adds, "[t]his clear detailed standard should contain definite thresholds for compliance."

Although we have pointed out instances where we believe the draft report is not supported by the record of the Commission's enforcement actions in administering the FCPA, or by the results of the GAO survey on which the draft report is based, and identified a number of considerations that are often overlooked by critics, the Commission can acknowledge that at least some of the concerns that have been expressed have a degree of merit. A number of these concerns were recognized, for example, in Chairman Williams' statement of the Commission's policies before the AICPA.

With respect to the recommendations in the GAO's draft, which appear to be made within the framework of the existing law, we are not sure what is intended when the draft report calls for a clear definite quantitative threshold that will "clearly tell companies the degree of precision needed to comply with the Act's accounting provisions" (page 35). First, it should be noted that the differences in the two accounting provisions require different standards adapted to the purposes of each section. In addition,

the recommendation appears to contemplate some kind of an arithmetical standard that could be inconsistent with the principle of maintaining accountability for assets and too rigid and inflexible to be practicably applied, given the vast differences in the circumstances of the issuers subject to the accounting provisions.

For example, in the context of the recordkeeping provision, does a "clear definite quantitative" threshold mean that transactions may be recorded at an amount that differs by 5%, 10% or even 25% from the amount at which it occurred, or is GAO suggesting that the Commission propose that transactions below some arbitrary figure such as $10, $100, $1,000 or $10,000 need not be accurately recorded? With respect to the internal accounting controls requirement, is the GAO suggesting an across-the-board rule that companies may disregard the risk of loss of cash or other assets as long as it is below some arbitrary figure such as $500, $5,000, $25,000 or more? If this is not what is contemplated, precisely what does the draft report suggest?

In this context, the GAO recognizes that a "materiality" standard could establish "a benchmark below which questionable corporate practices may be exempt" (page 33). Accordingly, the GAO recommends (id.) that:

> "qualitative characteristics in addition to quantitative thresholds be developed. An example would be a requirement that all intentional actions by top corporate management are material regardless of the dollar amount."

There is a good potential in this idea. 42/ There may also be other mitigating standards that could be used to limit liability in a manner consistent with the purposes of the Act. However, by emphasizing what appears to be an arithmetical approach or calling for detailed thresholds, we believe the recommendations of the draft report are unduly narrow. We support the concept that, to the extent it can be demonstrated that there are problems with the terms of the Act that need to be corrected, standards that are both workable and more understandable should be considered.

Finally, to the extent that the GAO draft proposes that the Commission develop new standards "with input from Justice, the corporate community and the accounting profession * * *" (page 35), we agree that the Commission should seek the views of these and all interested parties. However, we believe this should be done within the context of the Commission's normal administrative procedures of soliciting comment from the entire community affected by interpretive views expressed by the agency under the Act.

42/ We are concerned, however, that the approach recommended in the draft report would permit the falsification of corporate records by persons below the level of "top" management, as long as it was in an amount less than the arithmetical threshold it proposes.

Chapter 4: ISSUES SURROUNDING THE ANTIBRIBERY PROVISIONS

A. General Comments

The GAO survey reflects that 79.5% of the respondents viewed the clarity of the bribery provisions as either "adequate" or "more than adequate" while only 8.8% expressed the view that the clarity of the provisions was either "inadequate" or "very inadequate". In addition, as we have earlier summarized, more than 76.5% stated that the Act "has" or "probably has" been effective in reducing questionable overseas payments; only 5% asserted that the Act "has not" or "probably has not" been effective.

Moreover, as we have already noted, 87.5% of the companies that engaged in foreign business reported that they had either experienced no decrease in business or only a minor decrease in business as a result of the Act. In contrast, only 12% of the respondents reported a decrease in business that could be characterized as "moderate" and only .6% of the respondents indicated that they had suffered a "great decrease" in business. These findings are remarkable, particularly in view of the fact that the GAO's questionnaire does not distinguish between losses of business that resulted from the clear prohibition of transactions that cannot be effected without bribery and those cases in which it is alleged that businesses have refrained from engaging in overseas transactions that might be legitimate as a result of "uncertainty" as to the meaning of the Act. If, as appears probable, most of the "lost" business involved transactions that are clearly prohibited by the bribery provisions, the remainder representing cases in which possibly legitimate export opportunities were lost as a result of uncertainty must be very small.

Despite the survey data reflecting that the bribery provisions have been effective in achieving the purposes the Congress sought to achieve, and are not as ambiguous as some have suggested, the draft report deals exclusively with allegations that confusion exists "over what constitutes compliance with the Act's * * *" prohibitions against bribery (see page 36). The draft report adds, despite the survey data noted above, that these alleged ambiguities "have been cited as possibly causing U.S. companies to forego legitimate export opportunities."

As in the case of the accounting provisions, the draft report repeats these criticisms, as if they should be accepted at face value, without an independent analysis of whether they actually have merit. For example, there is no analysis of the implications of the survey data noted above. The empirical data compiled in response to the GAO's questionnaire indicate that some criticisms of the Act may be without merit, or exaggerated, and that only a relatively small portion of the business community has experienced either difficulty in understanding the law or a significant loss of business.

In this context, the Commission, in February 1980, requested comments concerning the impact and operation of the bribery prohibitions in order to ascertain the extent to which criticisms of the Act had substance and what

actions, if any, the Commission could take in response to these concerns. 43/ Only 14 comments were received despite the four-month comment period. As a result, the Commission did not have enough information properly to evaluate the concerns that were expressed by the commentators. 44/

In analyzing those comments, the Commission pointed out that "the limited response appears inconsistent with published reports that there is widespread concern and uncertainty on the part of public companies and some individuals as to the applicability of the bribery provisions to particular transactions." 45/ The results of the GAO's survey provide additional evidence that these concerns may not be as serious as many critics of the Act have supposed.

In addition, the criticisms of the Act the draft repeats are, for the most part, unidentified and anonymous. This is particularly important in view of the fact that the responses to the GAO questionnaire do not provide data that supports the bulk of the analysis set forth in the draft report. Except for the data noted above, the questionnaire was not designed to elicit such information concerning the impact and implementation of the bribery provisions.

The primary source of the criticisms and analysis reflected in the draft is a report that is improperly characterized (see page 38 and passim) as "a September 1980 report of the President on export promotion functions and potential export disincentives * * *." The GAO draft overlooks the fact that, in submitting that report to the Congress, the President made clear that he was submitting two reports and that the report relied upon by the GAO does not reflect his views:

> "I am submitting today my report on these matters along with the full text of the comprehensive review, which was prepared by the Secretary of Commerce and the U.S. Special Trade Representative. Their detailed review, while not a statement of Administration policy, reflects an extensive canvass of the views of our exporting community * * *." My report expresses this Administration's policies" (emphasis added).

43/ The Commission's request for comments and the public comments received in response to that request are not mentioned in the draft report; the draft merely refers to the Commission's statement, which was made in response to some of the comments, that it will not take enforcement action in any case where an issuer seeks, and receives, a favorable letter from the Department of Justice under the Department's FCPA Review Procedure prior to May 31, 1981.

44/ Securities Exchange Act Release No. 16953 (Feb. 21, 1980); 45 Fed. Reg. 12574 (Feb. 26, 1980).

45/ Securities Exchange Act Release No. 17099, supra.

Thus, the President pointedly disassociated himself from the more voluminous report (hereinafter referred to as the Klutznick/Askew report) that the GAO draft relies upon for the bulk of its background data and analysis. The GAO should at least point out the distinction that the President made in submitting the two reports to the Congress.

The draft report recognizes (page 48) that "rigorously defined and completely unambiguous requirements may be impractical and could provide a roadmap for corporate bribery." However, there is no discussion as to how the desire for greater clarity could be reconciled with the policy of the Congress to eradicate corporate bribery of foreign officials. Moreover, neither the draft report nor the critics whose views are reflected in the draft, have proposed constructive suggestions for alternative formulations, which would both satisfy the desire for greater clarity and yet be practical, consistent with the purposes of the bribery prohibitions and flexible enough to deal with the wide variety of transactions that must be encompassed.

B. The Relationship Between the Commission and the Justice Department's FCPA Review Procedure

Because the FCPA Review Procedure is a program of the Department of Jusice, we do not have detailed comments concerning the portion of the draft report that discusses the review procedure. However, the reference at page 42 to the Commission's position "that it will not take enforcement action against any company that receives a favorable Justice review letter" under that Procedure should be qualified to make clear that it applies only to review letters issued prior to May 31, 1981. As the report subsequently notes, the Commission will review its position, prior to that date, to determine what, if any, further action it should take.

The draft report is inaccurate in asserting that Commission participation in the FCPA review procedure "would have been in line with SEC's current policy of issuing administrative interpretations of laws and regulations when requested by interested parties" (page 44). The draft report fails to understand the nature of the administrative interpretations that the Commission does issue. These interpretations are provided to assist persons and entities in complying with provisions that, unlike the antifraud provisions and the bribery prohibitions, are of a technical and regulatory nature. In contrast, Sections 103 and 104 of the FCPA proscribe the making of any payment or gift "corruptly" to a foreign official, political party, or candidate for foreign political office in order to assist in obtaining, retaining, or directing business to any person. The determination of whether or not a person subject to those provisions intends to make a payment or gift "corruptly" will often require an evaluation of circumstantial evidence to determine whether the person making the payment or gift did so with a "corrupt purpose." Accordingly, the nature of the inquiry differs significantly from that involved in providing interpretations of regulatory statutes or rules that do not turn on the question of intent, or in issuing "no-action" letters in the context of such provisions — a method that the Commission has long employed to provide guidance to the public. Under these circumstances, it appears that questions concerning the motive

or intent of those engaging in conduct which appears to come within the terms of the FCPA can best be resolved by corporate officials and their professional advisers, who have access to all the relevant facts bearing upon intention.

C. The GAO's Recommendations

The draft report states a concern (page 47) "that alternative ways of providing guidance are needed to resolve the ambiguities in the Act's anti-bribery provisions." As noted above, the draft assumes, without an independent analysis by the GAO, that the criticisms expressed by some anonymous members of the business community with respect to the bribery prohibitions accurately reflect the existence of "ambiguities" in those provisions and that those "ambiguities" are so serious that an administrative or legislative response is required. The GAO draft makes this assumption despite the fact that 79.5% of the respondents to its questionnaire rated the clarity of the bribery prohibitions as adequate or more than adequate, while only 8.8% of the respondents (approximately 17 respondents out of 185) rated those provisions as inadequate or very inadequate. These facts and the fact that any business "lost" as a result of uncertainty must be very small are, inexplicably, mentioned nowhere in the draft report.

Nevertheless, the GAO proposes to recommend (page 49) that the Commission and the Justice Department "[o]ffer legislative proposals to reduce the ambiguities." This seems premature in view of the lack of credible and verifiable data as to the need for such legislation. In fact, the questionnaire data points to the conclusion that the alleged ambiguities are not as serious as some had supposed. Moreover, as noted above, neither the GAO draft nor the critics whose criticisms are repeated have made specific suggestions for changes that would both provide greater clarity and be consistent with the purposes that the Congress sought to achieve in adopting the bribery prohibitions.

The draft report also recommends (page 49) that the Commission and the Justice Department "[p]rovide additional guidance to the business community through the use of hypotheticals." Although the draft report notes that "some government agencies and corporate officials" have expressed a desire for "guidance" in the form of hypotheticals, such an approach would be of little value. As noted above, the concerns that have been expressed with respect to the bribery prohibitions result, for the most part, from the fact that the statutory standards require determinations as to a person's state of mind -- determinations that often require an evaluation of circumstantial evidence bearing on the question of intent. Hypothetical analysis is not suited to such an evaluation and could easily be misconstrued. Accordingly, it would not be appropriate for Justice and the Commission to "be jointly bound by any such guidance" as the GAO draft suggests (page 49). Finally, and perhaps most important, it would be unwise for the Commission to attempt to issue interpretations in the context of hypotheticals; the discipline inherent in dealing with a concrete set of facts, and with persons or entities who may express differing views as to proper application of the law, often bring to light issues and problems that would not be immediately apparent in a hypothetical situation. This results in a more sound and judicious decisionmaking process.

U.S. Department of Justice

Criminal Division

Office of the Assistant Attorney General

Washington, D.C. 20530

JAN 19 1981

Honorable Harold M. Williams
Chairman
Securities and Exchange Commission
500 North Capitol Street, N.W.
Washington, D.C. 20549

Dear Mr. Chairman:

This Department is in the process of preparing our formal comments on a recent draft Report by the General Accounting Office entitled "The Foreign Corrupt Practices Act." As part of that process, since our two agencies share enforcement responsibility for the Foreign Corrupt Practices Act, our staffs exchanged drafts of the comments which each had prepared on those portions of the GAO report which relate to the antibribery provisions of the Act. I have had the opportunity to review a draft of that portion of the Commission's comments, and as a result I would like to request that the Commission exercise its discretion to delete the material contained on pages 28 to 33 of those comments.

These pages which are of concern to us contain a detailed legal analysis of five provisions of the FCPA. Although we agree with many portions of that legal analysis, we have serious reservations about other portions. In our judgment the pages in question, if formally approved by the Commission and transmitted to the GAO, would effectively constitute advisory opinions on some of the Act's most important and controversial provisions and could seriously undermine future criminal prosecutions under the antibribery sections of the Act. Comments on a GAO report do not seem to us to be the best vehicle for either of our two agencies to provide guidance to the business community under the Act. The time pressures involved in responding to the GAO draft Report are not conducive to the carefully reasoned resolution of any differences that may exist between our two agencies as to how to provide guidance and what the nature of that guidance should be.

If the Commission is now of the view that guidance to the business community, in the form of opinions and interpretations of the Act, is warranted, our two agencies should immediately initiate discussions about the form and content which such guidance should take. The necessary time could then be taken to develop joint positions on the Act to the extent that is appropriate.

I would anticipate that if, in the future, the Department of Justice were to publish any interpretations of the anti-bribery provisions of the Act or were to recommend any changes in these provisions of the Act, it would do so only after consultation with the Commission.

Sincerely,

Philip B. Heymann
Assistant Attorney General
Criminal Division