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THE FOREIGN CORRUPT PRACTICES ACT: THE CHAFEE AMENDMENTS

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It is a great pleasure to be here with you this afternoon to discuss proposed changes in the Foreign Corrupt Practices Act. In assessing the proposed changes, it is helpful to hold a little history before us as a lodestar. In this country regulatory legislation dealing with the financial markets has proceeded from two sources:

-- institutional change in the markets, such as recent changes in banking legislation. In those cases, the law is simply validating what the markets have already done.

-- a perceived sense of abusive conduct, of a breakdown in conventionally acceptable modes of behavior.

It is clear that the Foreign Corrupt Practices Act falls in the second category. There are always difficulties of scope and vagueness when broad regulatory steps are taken in a rush to respond to scandal, and the Act is no exception.

As you will recall, during the mid-1970's a pattern of bribes and questionable payments to foreign governmental officers by more than 400 American companies became public. In most countries such payments, while not always uncommon, were illegal. That conduct could not stand the light of day, and there were substantial political repercussions from its disclosure.

More importantly, the fact that this conduct was illegal affected related activities. False entries were made in corporate books and records and on tax returns, off-the-books slush funds were created, and substantial sums of cash were subject to uncontrolled discretion of individual officers. Whether from intention or sloppy management, senior executives and directors were often unaware of what was going on.

The Commission and the Congress were required to confront quickly three important and related issues in deciding whether any action should be taken in this area. First, if the amounts involved were not "material," why should anyone care? Second, what business is it of ours to enforce the laws of other countries? And third, why should we take steps that will make it harder for American companies to sell products abroad when international markets are becoming ever more competitive?

In thinking about those questions, it is essential to understand the special and technical meaning that lawyers and accountants have given to the word "material." It is certainly not congruent with the word "important." It refers to an amount large enough to influence an investor's judgment about a company's financial position or the results of its operations. In many cases the amounts involved in the questionable payment cases were not material in that sense.

In spite of that fact, prior to adoption of the Foreign Corrupt Practices Act, the SEC was inventive in thinking about other ways in which these payments might be considered material or otherwise disclosable. For example, a material amount of business may depend upon the payments, or their disclosure may be a necessary part of the company's description of its method of doing business. The Commission also argued that these payments bore on the integrity of management and were for that reason material to investors. Each of these theories has an element of logic. But in a more fundamental sense, each was beside the point. For the real point had little to do with investment decisions. Instead, what was posed was a classic legislative issue: Is that conduct appropriate for American companies in view of the fact that it violated foreign, and not American, law and that a prohibition would inhibit our export efforts?

Congress clearly answered that question in the negative. In the questionable payments area, it prohibited

-- payments "corruptly" made to foreign officials, political parties and candidates for political office abroad to influence a decision for the purpose of obtaining or retaining business, and

-- payments to other people if there is "reason to know" that they will be used to make payments to foreign officials or others in the prohibited group.

The Act's accounting provisions embody the entirely unremarkable conclusions that companies having public reporting obligations under the Securities Exchange Act should

-- maintain books and records, in reasonable detail, that accurately and fairly reflect the company's activities; and

-- devise and implement a system of internal accounting controls which provides reasonable assurances about the control and recording of business transactions and safeguarding of assets from unauthorized access.

<u>The Chafee Bill</u>

There are numerous ambiguities in both requirements. Senator Chafee has introduced a bill that would clarify many of them, but in some cases only at the cost of erosion of the Act's original objectives. I should emphasize that my comments on the Chafee bill are mine alone and do not necessarily reflect the views of the full Commission.

Senator Chafee's bill would change the statute's name to the "Business Practices and Records Act," and would confer exclusive jurisdiction over the antibribery provisions on the Justice Department. I support those changes. Although the Act deals with a broad range of business and accounting practices, its roots in financial pathology and its association with foreign corrupt practices have tended to distort consideration of some of the more technical issues.

<u>Antibribery Provisions</u>

Even though I agree that the antibribery provisions are more properly a concern of the Justice Department than of the SEC, I think some comment is in order on the numerous proposed changes in that area. The most important is the proposed elimination of the prohibition against payments to third parties where there is “reason to know” of the purpose to which the funds will be put. The bill would also go further than current law in permitting gifts and facilitating payments where their use is “customary.” The bill does not, however, reduce the Act’s basic prohibition against direct or indirect bribery.

I agree with the objective of clearing away ambiguity while retaining the basic prohibition against bribing foreign officials. Economically, bribery is a distortion of comparative advantage, causing purchases to be made on grounds other than those which most efficiently allocate economic resources. It undermines foreign policy objectives by damaging our national image and detracting from our political effectiveness. It may also contribute to weak and unstable governments in strategically critical areas of the world.

Almost all countries have national laws against bribery. The United States, however, has been the only country in the world to extend the application of national bribery laws beyond its borders and we have not been successful in convincing other countries to follow our lead. Unilateral action attempting to control this practice in international markets has proven to be effective only to a limited degree: it has reduced bribery by Americans in world markets, but has not influenced the behavior of other nations. Although a U.N. working committee has completed a draft agreement governing international illicit payments, efforts by the United States to negotiate its acceptance by other nations have not been successful as yet. Without cooperation from at least our major trading partners, the United States will continue to be at some disadvantage from a law placing Americans on unequal footing with the rest of the world.

This issue is only one aspect of the more general set of problems that arise from the increasing internationalization of national economies. When countries compete in world markets, their rules for ordering their national life become matters of competitive concern. But that is only the beginning, not the end of the story. If the existence of differing practices were enough of a reason to eliminate the higher standards, then internationalization would become simply a race to the lowest common denominator. Thus, the real challenge in this new and very difficult world is to examine our own views carefully. We must be satisfied that rules that disadvantage American companies in international markets represent enduring values, eliminating unnecessary competitive differences that stem from nothing more than differences in approach.

Just as it is important to avoid self-righteousness, it is also essential to avoid self-delusion. If we persist in the notion that bribery is not an appropriate way to conduct international business, then we should look very carefully at the proposed elimination of the “reason to know” standard in Senator Chafee’s new bill. International purchasing agreements are commonly negotiated through local agents who receive commissions. In the past, questionable payments have often been made from the proceeds of large commissions. In considering whether to eliminate the “reason to know” standard, we must be satisfied that it is not merely an invitation to hypocrisy and a return to the practices that most agree should not be encouraged.

<u>The Accounting Provisions</u>

I would like to turn for a few minutes to the accounting provisions of the Act. You will recall that they require the keeping of accurate books and records and the maintenance of adequate systems of internal control. The Act’s formulation of these obligations was taken from the accounting literature. Indeed, one might well argue that these obligations are not new, and that they represent only what is required by the application to management of established fiduciary principles. Moreover, these rules have been recognized as a necessary precondition to the preparation of financial statements in compliance with generally accepted accounting principles.

If these principles are so well-recognized, what was all the fuss about? Let me suggest three reasons. The first is historical. The mandate of <u>good accounting</u> practices became associated with <u>foreign corrupt</u> practices, and a primary concern of the SEC’s Division of Enforcement and the Justice Department’s Criminal Division. That is enough to make anyone concerned with financial accounting uncomfortable.

The second reason grows out of the dominance of independent auditors in the theory and literature of accounting. Like all of us, independent auditors view the world through the lens of their special responsibilities. In this case it is to insure that financial statements fairly present a company’s financial condition and results of operations. That objective gives form and content to all of the uncertainties and ambiguities of the accountant’s profession.

Yet the experience of the 1970’s clearly went a step beyond concerns about fair presentation. It would be fair to say that the accounting provisions of the Act were adopted precisely because of concern that traditional concepts of materiality left open a range of conduct that the Congress thought was improper.

The third cause of discomfort is an amalgam of the first two and the difficulties that come with reducing accepted non-legal principles to precise written rules, putting teeth in those rules and hanging them in front of lawyers and accountants to shoot at. It’s one thing to say “be reasonable”; it’s quite another to say, “I’ll put you in jail if you are not.”

Criticism of the Act’s accounting provisions fall into four main catagories:

-- The recordkeeping provisions can be read to require perfect books, records and accounts, with liability attaching to even the smallest mistaken entry on any piece of paper.

-- The internal controls provisions require universal compliance with a perfect system which meets the unstated specifications of the Commission and the Justice Department, without regard for the good faith business judgments of management.

-- The Act can be violated by inadvertent action, taken in good faith, perhaps even without the knowledge of the members of corporate management who are responsible for these matters.

-- Liability may arise under the Act by reason of the conduct of subsidiaries of a issuer which may not be under the control of the issuer.

Senator Chafee has responded to these concerns by proposing that the Act be amended, among other things, to

-- include a financial statement materiality standard,

-- incorporate a “scienter” (knowledge) standard for violation of the recordkeeping provisions,

-- tie the recordkeeping and internal accounting control standards to generally accepted accounting principles, and

-- provide that a company owning less than 51% of a subsidiary need make only a good faith effort to insure compliance.

Interestingly, a few months ago the Commission responded to the same concerns by authorizing its Chairman to issue a policy statement, and I would like to devote a few minutes to summarizing it for you.

-- <u>Recordkeeping</u>. The Act’s recordkeeping provision requires that a company maintain records which reasonably and fairly reflect the transactions and dispositions of the company’s assets. This provision is intimately related to the requirement for a system of internal accounting controls, and we believe that records which are not relevant to accomplishing the objectives specified in the statute for the system of internal controls are not within the purview of the recordkeeping provision. Moreover, inadvertent recordkeeping mistakes will not give rise to Commission enforcement proceedings; nor could a company be enjoined for a falsification of which its management, broadly defined, was not aware and reasonably should not have known.

-- <u>Internal accounting controls system</u>. The Act does not mandate any particular kind of internal controls system. The test is is whether a system, taken as a whole, reasonably meets the statute’s objectives.

"Reasonableness depends on an evaluation of all the facts and circumstances.

-- Deference. Private sector decisions implementing these statutory objectives are business decisions. And reasonable business decisions should be afforded difference. This means that the issuer need not always select the best or the most effective control measure. However, the one selected must be reasonable under all the circumstances.

-- State of mind. The accounting provisions' principal objective is to reach knowing or reckless conduct. Moreover, we 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.

-- Status of subsidiaries. The issuer's responsibility for the compliance of its subsidiaries varies according to the issuer's control of the subsidiary. The Commission has established percentage-of-ownership tests to afford guidance in this area.

What are the areas of difference between the Commission's policy statement and Senator Chafee's bill? The principal one is the application of a materiality standard to both the books and records and the internal controls requirements. There are other respects in which I would make suggestions for changes in the Chafee bill, but they are less important.

As for materiality, as I noted earlier, the accounting provisions were adopted precisely because of the fact that traditional concepts of materiality, which are the bedrock of the Federal securities laws, did not provide a useful means of dealing with these problems. Materiality is a notion that deals with the final product of the process of accounting, financial controls and reporting. But a properly managed company has control over transactions that are far smaller than those which have a material impact on the final result. For example, how would an inventory control system for a supermarket be designed to permit access to assets in accordance with management's authorization only to a degree that would be material in the preparation of financial statements? Is that really what we mean when we speak of accountability for assets? I do not think so. The two concepts deal with quite different issues.

On the other hand, I think it would be a mistake to dwell too much on the differences between the Chafee bill and the Commission's policy statement. The actual and potential common ground is great, in my judgment. If the Congress chooses to act in this area, I believe the dual purposes of preserving the Act's original objectives and eliminating much of the uncertainty can be achieved.