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IMPLEMENTATION OF THE FOREIGN CORRUPT
PRACTICES ACT: AN INTERSECTION
OF LAW AND MANAGEMENT

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Section of Business, Banking
and Corporation Law
American Bar Association
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It is both a pleasure and an honor for me to address the Section of Business, Banking and Corporation Law again this year. As an individual who has had the opportunity to participate firsthand -- from the several perspectives of practicing attorney, corporate executive, director, academic, and now, government official -- in the dynamic process by which business and the legal profession interact, I recognize the crucial role which those in this room play in guiding both our corporate and legal communities. For that reason, I consider the opportunity to address this group as one of the most important and rewarding engagements on my speaking calendar.

In my remarks last year, I set forth the reasons why I believe that attorneys must commit their talents and ingenuity to furthering corporate accountability. This task is one which should be of direct concern to members of the corporate bar. The political freedoms which we, as lawyers, have over the years assumed a special responsibility to preserve, are directly impacted by the public attitudes and reactions toward the private business sector -- the chief

source of the economic wealth necessary to achieve our nation's social aspirations. Because of its unique role in shaping corporate behavior, the bar has, in turn, the ability to influence those attitudes and reactions significantly for good or ill.

One of the themes I sounded last August was that lawyers, in helping to shape a philosophy of corporate accountability which will permit the business community to retain public trust and support, must look beyond the law. I made that point last year with these words:

"We must decide, consciously and deliberately, what role ethical considerations will play in the decision-making of American business. What is legal and what is ethical are not synonymous. We tend to resort to legality often as a guideline; in that sense, ethics is on the wane and the age of the legal technician is in full flower." */

This tendency to don the technician's blinders and ignore the larger impacts of the law is, of course, not confined to the private sector. Government lawyers -- perhaps even more than their private sector colleagues -- bear much of the guilt. The consequences, I believe, are reflected in

*/ M. Williams, "Corporate Accountability and the Lawyer's Role," An Address to the ABA, p. 24 (Aug. 8, 1978).

the current skepticism with which the public views lawyers, government, and the private business sector.

For that reason, I would like this afternoon to re-examine the theme of my remarks last year in light of what I consider a current case study in the interaction among the private sector, the corporate bar, and government -- the implementation of the newly-enacted accounting provisions of the Foreign Corrupt Practices Act. I want to discuss these apparently controversial requirements for several reasons. First, judging by the extensive effort which members of this Section obviously expended in producing a guide to the accounting provisions */ and the detailed July 31 joint comment letter which the Commission recently received from several of this Section's subcommittees, the Act and the Commission's recent rulemaking proposals which would complement it are obviously of great interest to many of the Section's members.

In addition, I want to examine the accounting provisions of the Foreign Corrupt Practices Act because the debate surrounding them highlights several facets of the

*/ Committee on Corporate Law and Accounting of the American Bar Association, "A Guide to the New Section 13(b)(2) Accounting Requirements of the Securities Exchange Act of 1934 (Section 102 of the Foreign Corrupt Practices Act of 1977)," 34 Bus. Law. 307 (1978).

larger dialogue over corporate accountability. These facets include extensive public scrutiny of corporate conduct widely viewed as unacceptable; a Congressional response to that scrutiny; governmental efforts to give meaning and content to the resulting legislative directive; a constructive response by some corporations and auditors, coupled with narrow interpretations and protest against further governmental intrusion and over-regulation by many others; and a small but vocal public faction which regards the legislation as inadequate and urges more stringent laws. In the face of these conflicting factors, giving meaningful content to the accounting provisions will not be easy and may prove impossible. If we fail, however, I am concerned that our failure will serve chiefly to furnish ammunition to those who demand still greater federal intervention into how and by whom public corporations are run.

The corporate bar is central to this interaction. To the extent that the profession takes the attitude that the new law should be viewed narrowly and treated as another governmental over-reaction, to be complied with grudgingly, in letter but not spirit, then the Act will accomplish little except to spawn litigation and harden the lines between those

who urge more pervasive federal control over corporations and those who advocate less. If, on the other hand, the response of the private sector, with counsel's help and guidance, addresses the concerns and public perceptions which motivated Congress in enacting it, then an important and constructive link in the evolving philosophy of corporate accountability will have been forged. And that link is one which, in my judgment, would do much to demonstrate the effectiveness of corporate self-discipline -- administered not primarily by government, but by each corporation in conjunction with its outside accountants and counsel.

The Origins of the Foreign Corrupt Practices Act

As most of you are aware, the subject of this case study in corporate and legal interaction is an amendment to the Securities Exchange Act enacted by Section 102 of the Foreign Corrupt Practices Act of 1977. */ It is hardly necessary to detail the circumstances and practices which led Congress, without a dissent, to pass the Act in December 1977. Of course, it is easy to exaggerate

*/ Title I of Public Law 95-213, 91 Stat. 1494 (Dec. 19, 1977), codified as Sections 13(b)(2)(A) and (B) of the Securities Exchange Act of 1934, 15 U.S.C. 78m(b)(2)(A) and (B).

the number of companies that engaged in the practices, the magnitude of the dollars involved, and the extent to which questionable activities represented corporate policy rather than the unauthorized schemes of misguided individuals. Nonetheless, for much of the public, confidence in the integrity of the business community was understandably shaken, and, for some, existing suspicions were confirmed. In that climate, Congress obviously felt compelled to respond.

The highly-publicized specific conduct which filled the media were symptomatic of a more fundamental problem. Breaches in corporate recordkeeping and control called into question the ability of directors and top management effectively to oversee the corporation's employees, particularly those working in far-flung subsidiaries. As the Commission's May 12, 1976 Report on questionable payments put it,

"the fact that so many companies have been able to elude the system of corporate accountability strikes us as a matter requiring significant action." */

*/ Report of the Securities Exchange Commission on Questionable and Illegal Corporate Payments and Practices, 95th Cong., 1st Sess., at a (1976).

These breakdowns also cast doubt on the ability of the independent auditor and outside counsel to discharge their responsibilities to the accountability process. In some instances, breaches in recordkeeping and control concealed the activity from the scrutiny of auditor and counsel. Nonetheless, the facts of many of the cases caused some in Congress to wonder how questionable corporate payments, often involving substantial sums, could have occurred if these professionals -- particularly accountants -- were doing their job. */ While Congress did not expressly define a role for accountants and lawyers in the Foreign Corrupt Practices Act, it was, I think, implicit that they would have one in its implementation. For example, in testifying on the legislation which ultimately became the internal control requirement, my predecessor, SEC Chairman Roderick Hills, stated flatly that, "upon the passage of this legislation, we would, of course, impose a requirement upon outside auditors that they certify the adequacy of

*/ See, e.g., Federal Regulation and Regulatory Reform, Report By the Subcommittee on Oversight and Investigations of the Committee on Interstate and Foreign Commerce, House of Representatives, 94th Cong., 2d Sess. 30-42 (1976).

such [internal] controls." */ And, whatever the ultimate fate of the Commission's recently proposed rules in this general area, **/ it can hardly be surprising that accountants and attorneys are being called upon to participate in giving meaning to the accounting requirements of the Foreign Corrupt Practices Act.

The Accounting Provisions of the FCPA

I want to turn now from the concerns which motivated Congress to the text of the legislation which resulted. As you know, the statutory language in question requires corporations subject to the registration and reporting provisions of the securities laws 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 * * *." ***/

In addition, public companies are required to "devise and maintain a system of internal accounting controls

*/ Prohibiting Bribes to Foreign Officials, Hearing before the Committee on Banking, Housing and Urban Affairs, United States Senate, 94th Cong., 2nd Sess., at 3 (1976). See also id. at 19.

**/ Securities Exchange Act Release No. 15772 (April 30, 1979), 44 FR 26702.

***/ Section 13(b)(2)(A) of the Securities Exchange Act of 1934.

sufficient to provide reasonable assurances" that specified objectives are met. */ In essence, those objectives are that assets be safeguarded from unauthorized use, that corporate transactions conform to managerial authorization, and that records be accurate.

A typical first reaction -- at least a nonlawyer manager's first reaction -- to these requirements would be, I think, one of nonchalance: The law simply recites 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. For that reason, internal accounting controls have long been recognized as constituting an important element in an effective management system, and the responsibility for ensuring the existence of adequate internal accounting controls has correspondingly always been recognized as that of management. Internal accounting controls are essential, not only to assure the security of assets, but also to

*/ Id., Section 13(b)(2)(B).

assure the accuracy of financial and operating data upon which the company relies in reporting earnings, both annual and interim, and in managing its operations and internal decision-making. Indeed, at least one key Congressional participant in the legislative process was somewhat bemused by the need for the accounting provisions since public corporations would presumably already have recordkeeping requirements and internal control mechanisms in place, and believed that the Commission, in any event, appeared to have the power under pre-existing disclosure statutes to require such measures if they were absent. */

What then is the impact of the accounting provisions? First, they should encourage management systematically to review the control procedures by which it and the board ensure that corporate assets are expended in accordance with the policies which top management and the directors have promulgated and that corporate records accurately reflect corporate activities. While many companies and managements have a basic "sense" that their

*/ See 1977 House Hearings (remarks of Congressman Eckhardt), Foreign Corrupt Practices and Domestic and Foreign Investment Disclosure, Hearing Before the Committee on Banking, Housing and Urban Affairs, United States Senate, 95th Cong., 1st Sess., at 227 (March 16, 1977).

system is effective -- as evidenced perhaps by the fact that they know of no failures or that their auditors are able to certify their financial statements -- it is clear that this in itself does not provide adequate assurance. And, since business is dynamic and changing, some sort of periodic review is necessary to ensure that control systems keep pace. Systematic evaluations of the adequacy of internal accounting control systems have, however, not been traditional. Now that many managements are undertaking to make such evaluations, much effort is being devoted to establishing methodologies and guidelines to assist and formalize that process.

Questions are frequently raised concerning the resulting costs. Effective management depends, of course, upon the exercise of informed judgment in spending corporate funds, as well as in protecting them, and I do not read the accounting provisions as a mandate to abdicate that judgment in favor of the unthinking application of costly new controls. The installation of recordkeeping and control procedures which foster operation of the enterprise in compliance with corporate policy and the law may be expensive for those companies which lack them. However, the idea that business ventures funded by the investing

public should expend whatever is reasonably necessary, in the exercise of good judgment, to install such mechanisms -- as a matter of effective management, let alone legal requirement -- hardly seems radical.

Second, the accounting provisions should encourage a searching analysis of the attitudes and institutional dynamics within which the issuer's recordkeeping and internal control mechanisms operate. The AICPA's special committee on internal control has labelled this amorphous but critical constellation of factors the "control environment." */ 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. And, in the last analysis, the term "control environment" is simply a shorthand for the attitudes of the people who must run the system. In particular circumstances, fostering the right attitude may require codes of conduct for corporate employees, enhanced internal audit mechanisms, changes in the way the company responds to the recommendations of independent auditors, and possibly other concepts outside

*/ AICPA, Report of the Special Advisory Committee on Internal Accounting Control 12 (1979).

the repertoire of those who are used to thinking of controls narrowly and in isolation from the environment in which they operate. The key is an approach on the part of top management which makes clear what conduct is expected, and that conformity to those expectations will be rewarded while breaches will be punished.

The role of the board of directors in making clear its expectations relative to corporate conduct, in stimulating respect for control mechanisms, and in overseeing compliance is itself an important component of the control environment. I have spoken on other occasions concerning other aspects of the board's role and ways in which it can be enhanced. I do not believe that the accounting provisions compel corporations to adopt my specific suggestions or any others concerning board structure. I do believe, however, that the new Act will encourage assessment and study, in each corporation, of the ways in which the board of directors can assure a strong control environment.

Third, the accounting provisions should encourage management to document its control system in order to assess the system and conclude that it satisfies the requirements of the Act. Without the discipline of documenting the dimensions of the system and its potential areas of weakness, it is

difficult to understand how any management could satisfactorily assess, let alone demonstrate, its compliance. And, if the need to make such a demonstration seems academic, bear in mind that system adequacy will typically become an issue only after there has been a system failure. The ability to show that the breakdown was an isolated lapse in an adequate control system rather than evidence of management's failure to maintain an adequate system will be influenced strongly by the quality of the pre-existing documentation. Without a record of management's evaluation process, how many internal control systems will appear "adequate" when particular recordkeeping errors or employee deviations from management directives are exposed to the scrutiny of hindsight?

As I noted earlier, the process of review and documentation -- since it may not have been done formally in the past and since it demands a commitment of management's time and resources -- will entail costs. It should, however, pay dividends. The effort will highlight ways in which management can create and assure a system which is more effective and reliable in monitoring and directing the enterprise. The process should also have the effect of encouraging the independent accountant to focus on auditing

internal controls, rather than auditing around them as is frequently done today. This change in emphasis alone will, I believe, significantly increase the benefits of the auditor's work and the efficiency with which it can be performed. And that, in turn, can lead to reduced audit fees over the long run.

Finally, the process of reviewing and, if necessary, strengthening controls should ultimately enhance public confidence in the corporate sector. It will enable the corporation and the business community to separate more clearly those incidents which reflect upon the accountability ethic and the morality of the private sector from more isolated instances of system subversion or human frailty -- inherent limitations which mean that no system can be expected to achieve zero-defects or to be fail-safe. Further, the strengthening of controls will, in my view, mean that the type of questionable corporate conduct which fuels the movement for detailed, direct federal oversight of corporate decision-making will be less likely to recur. That is a goal which every member of the business and legal communities should share.

I do not mean to suggest that concern about the impact of new Section 13(b)(2) is irrational or unfair. I

can certainly understand the apprehension of some over the dangers of unthinking application of the accounting provisions. The statute lacks any of the traditional limitations familiar in the federal securities laws, such as the materiality concept or the scienter standard applicable in certain private actions. Under these circumstances, it is not surprising that some have predicted that compliance with the Act will be terribly costly; that government or private litigants will refuse to perceive that no internal accounting control system can be fail-safe or foolproof; and that courts may not fully respect the tradeoffs between costs and benefits which are appropriate in structuring an internal control system. It is difficult to deal satisfactorily with these concerns in the abstract, absent concrete fact situations. It would be unfortunate, however, if implementation of the Act served to discourage the correction of errors; to inhibit changes and improvements in existing control systems; or discourage auditors, both independent and internal, from continuing to identify opportunities to improve accounting control and bringing them to management's attention, for fear that any of these would necessarily be construed as admissions of inadequacy.

Constructions of the Act which have such effects would, I think, be contrary to Congress' intent and to a fundamental strengthening of corporate accountability. Implementation needs to be shaped with sensitivity and sensibility.

The Commission's Regulatory Response

I want now to shift my focus from corporate management to the Commission. The regulatory steps which we have taken to foster the goals of the Act are designed -- not to increase federal intrusion in corporate affairs -- but rather to stimulate managements to undertake the kind of self-examination I have just described. They are not prescriptive. On the contrary, the Commission has gone to great lengths to make clear that there is no single, universally appropriate set of controls. We encourage reliance on management's informed judgment to select the controls which best fit the circumstances. The objective of this approach is to place the responsibility on intelligent and enlightened managements and boards.

As I mentioned earlier, the Commission recently proposed rules to require a management statement on internal accounting controls and to require an independent accountant to render an opinion -- somewhat different in scope from the traditional auditor's certificate -- on this new management

filing. */ In fashioning this proposal, our objective was to meld the management report concept recommended by the Cohen Commission, **/ the Financial Executives Institute, ***/ and other elements of business leadership with the national policy Congress adopted in the accounting provisions of the Foreign Corrupt Practices Act. The Commission attempted to accomplish this goal in a way which would provide investors with a better understanding of the strengths and weaknesses of issuer internal accounting control systems, emphasize management's responsibility, and encourage the kind of systematic review of controls I have outlined above. This type of approach, I believe, harmonizes the accounting provisions with the disclosure philosophy which underlies the balance of the Securities Exchange Act. Further, it would place the responsibility for compliance where it belongs -- on corporate management, directors, and their professional advisers -- and should help ensure that management and boards focus their attention on the requirements of the new law now rather than being unpleasantly surprised later on.

*/ See second footnote, p. 12, supra.

**/ Commission on Auditors' Responsibilities, Report, Conclusions, and Recommendations 76 (1978).

***/ See Letter, dated June 6, 1978, from C. C. Hornbostel, President, FEI, to all members.

Nonetheless, this rulemaking initiative has generated intense opposition. I do not want to explore in any detail here today either the specifics of the proposal, which is currently under Commission consideration, or the comment letters. I can, however, say that in proposing this report, it was not the Commission's objective to open the door to a program of compliance reporting applicable to the full range of federal law; to lay the ground work for an enforcement effort aimed at ferreting out trivial arithmetic or other bookkeeping inaccuracies; to entrap issuers which promptly detect and rectify errors in their records; or to accomplish the other horrors which some of the comment letters envision. On the contrary, the objective of our proposals -- indeed, in my view, the objective of the statute -- is 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.

Whether our proposals would accomplish these ends is something the Commission will have to determine in the framework of the rulemaking process. It is, however,

difficult to understand how our management statement rule, if adopted, would require responsible corporations to do much beyond what they would do, absent the rule, in order to comply with the Act. Moreover, although there may be persuasive objections to our proposals, I find it disappointing that much of the opposition seems to have lost sight of the fact that controlling the business is a basic, familiar managerial goal. I would urge that, whether or not our reporting proposal becomes a reality, compliance with the Act be approached with that principle in mind.

The Lawyer's Role

The final actor whose role in the implementation of the Foreign Corrupt Practices Act I wish to consider is the corporate lawyer. In my view, counsel's job is to alert management to its responsibilities under the Act, to aid management and the board in structuring the review and decision-making processes which an evaluation of controls entail, to help to document that effort, and to encourage management to understand the broad corporate accountability concerns which motivated Congress in enacting the accounting provisions. In this way, the bar can, I believe, help assure corporate credibility through the translation of the new law into an effective accountability mechanism.

Counsel can, of course, approach the statute from a different direction. Lawyers who devise cramped, narrow interpretations of law, encourage corporations to do as little as possible in response to its enactment, and generally sound an alarm that the statute is a dangerous and costly federal incursion into private decision-making may be popular with some of their clients. They do little, however, to move forward the effort to create a corporate accountability framework generated within the business community rather than imposed from without. Rather, they encourage business to write off the accounting provisions as overly-intrusive and too costly to merit anything other than a grudging response. In an excellent statement on the implications of the Foreign Corrupt Practices Act, Joseph E. Connor, Chairman of Price Waterhouse, expressed a similar thought in these words:

"As a matter of personal conviction, I am opposed to the continuing encroachment of government into corporate affairs and our personal lives. But when a bill has been signed into law, or when a proposition has been adopted officially as regulation, fist-shaking becomes futile. The corporation, its owners, and the public must, instead, face the new situation squarely and take action to

obtain the greatest possible benefit from the necessary cost of compliance." */

Let me illustrate one way in which this philosophy applies to the accounting provisions. Various commentators, including the ABA guide, **/ have attempted to relate the new requirements to existing accounting literature by importing concepts from that realm -- such as the auditor's distinction between "errors" and "irregularities" -- into the Act. As the recent report of the AICPA's special advisory committee on internal control suggests, however, existing accounting material in the area has a different purpose and focus. ***/ And, more fundamentally, concentration on the financial statements as the sole objective of corporate records and internal accounting controls seems, to me, to be inadequately sensitive to the concerns which led to the Foreign Corrupt Practices Act. The statute was not enacted because Congress believed that corporations generally lacked internal controls adequate to permit the preparation of financial statements.

*/ J. Connor, "The Foreign Corrupt Practices Act: Implications for Directors," An Address to the Business Week Conference for Corporate Directors, p. 2 (June 7, 1979).

**/ See footnote, page 5, supra.

***/ AICPA, Report of the Special Advisory Committee on Internal Accounting Control 8, 10-11 (1979).

Rather, Congress perceived that there had been a breakdown or subversion of controls designed to safeguard assets, conform transactions to management's authorization, and to foster reliable recordkeeping. A control system adequate only for quantitative materiality in a financial statement context would be far too crude a tool to be useful to management; to construe the Act as if it were concerned only with financial statement accuracy makes Congress' work a mockery and does nothing to encourage the kinds of corporate responses necessary if we are to prevent the Act from becoming the first in a series of increasingly more stringent federal corporate accountability measures.

Even if financial statement materiality alone were the essence of the new law, it would not be good business. As I discussed earlier, those with internal control systems that meet the requirements of the Act go a long way toward assuring that the organization's efforts are directed towards implementing its goals and that it functions in the best interests of its owners, managers, and the public. By the same token, a negative attitude towards reliable recordkeeping and a meaningful control environment is infectious and self-defeating. It negates the control consciousness necessary to effective internal control and is likely to encourage

circumvention or override of controls in ways which cost the company both money and reputation. Thus, I believe that the business community would be better served by efforts to encourage examination of the positive corporate accountability potential of the accounting provisions, rather than by debate over the location of the outer legal perimeter of the statute.

Conclusion

I want to conclude with several caveats concerning the lawyer's role in corporate accountability. I do not suggest that counsel has the sole or exclusive responsibility for reshaping corporate accountability or for corporate compliance with the new law; that responsibility belongs, in the first instance, to the corporation and its officers and directors. Similarly, I also do not urge that lawyers be restrained or circumspect in their advocacy concerning the scope and meaning of the accounting provisions if they find themselves in the position of representing a client suspected of failing to comply with its requirements; quite clearly, in that situation, the lawyer is obligated to bring to bear the full range of his or her technical skills, within the broad limits of Canon 7 of the Code of Professional Responsibilities. And, finally, I am not suggesting that lawyers, as individuals or organized groups,

should refrain from making their views known concerning controversial legal issues; obviously, they are free to do so, and indeed should feel an obligation to speak out. The public benefits when they do.

I do, however, believe that, in undertaking these tasks, lawyers should acknowledge that their work has consequences outside of the law. In the area I have spoken about today, the implementation of the Foreign Corrupt Practices Act, the stakes extend to the future direction of this nation's private business community. Reasonable attorneys may, of course, disagree concerning how the Act should be implemented and what the impact of various approaches would be. I hope, however, that there would be little disagreement with the propositions that we need to strengthen public trust in our business sector and that the issue is very much open as to whether government's role in that process will be one of oversight or intervention. The work of the corporate bar will have a large influence on how that issue is resolved during the next several years.

Thank you.