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No. 77538-3-I

IN THE COURT OF APPEALS
OF THE STATE OF WASHINGTON

GEORGE E. ENGSTROM and JOHN E. STOCKWELL,

Plaintiffs/Petitioners,

v.

MICROSOFT CORPORATION,

Defendant/Respondent.

PETITION FOR REVIEW

THE SHERIDAN LAW FIRM, P.S.

John P. Sheridan, WSBA #21473
Mark W. Rose, WSBA #41916
Hoge Building, Suite 1200
705 Second Avenue
Seattle, WA 98104
(206) 381-5949

Attorneys for Petitioners

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A. Introduction and Identity of Petitioners

Petitioners George ("Eric") Engstrom and John ("Ted") Stockwell seek discretionary review by the Washington Supreme Court of the decision of the Court of Appeals terminating review designated in Part B of this petition. They allege wrongful discharge in violation of public policy against Microsoft, a publicly-traded company, claiming they were terminated for having reported "expensing [of] illegal prostitution masked as benign meal charges."[1]

B. Court of Appeals Decision

On May 6, 2019, the Court of Appeals affirmed the dismissal of Engstrom and Stockwell's claims, ruling they "failed to meet their burden to plead and prove that a stated public policy… may have been contravened." Engstrom v. Microsoft Corp., No. 77538-3-I (Wash. Ct. App. May 6, 2019) ("Slip Opinion") at 1. The Slip Opinion is attached at Appendix 1.

The Court rejected Petitioners' reliance on the potent and broad-ranging "books and records" provision of the Foreign Corrupt Practices Act of 1977 ("FCPA"), 15 U.S.C. § 78m(b)(2)(A), which was pleaded to demonstrate "there is a clearly established public policy against falsifying corporate records or books." See id., at 8-9. The Court of Appeals erred in relegating the reach and scope of the FCPA to "the bribery of foreign

[1] Slip Opinion, at 2.

officials[.]" Id. The reach and scope of the FCPA is much broader and supports the public policy articulated by Petitioners.

The Court likewise rejected Petitioners' reliance on "public policy under the whistleblower protection provisions of the Sarbanes-Oxley Act" (SOX), 18 U.S.C. § 1514A, *et seq*. See Slip Opinion, at 9-11. The Court ruled that "the policies behind the whistleblower protections of [SOX] do not apply here," reasoning that SOX was intended to only address "securities fraud." Id. Again, the reach and scope of SOX is much broader and supports the public policy articulated by the petitioners. The Court also ruled that Petitioners unduly delayed moving to amend their complaint to assert SOX's whistleblower provisions as a source of public policy and held, without evidence, that Microsoft would be prejudiced if the alternative source of public policy was pleaded. Id., at 12.

Engstrom and Stockwell filed a timely Motion for Reconsideration, which was denied on June 11, 2019.[2]

C. Issues Presented for Review

Issue No. 1 Does the decision of the Court of Appeals, which held that the claim Petitioners were fired for reporting a violation of 15 U.S.C. § 78m(b)(2)(A) does not "demonstrate that their discharge may have been motivated by actions that contravene a clear expression of public policy," conflict with this Court's decisions, which state that "[t]he question of

[2] The Order Denying Reconsideration is attached at Appendix 2.

what constitutes a clear mandate of public policy … can be established by … statutory, or regulatory provisions," Martin v. Gonzaga Univ., 191 Wn.2d 712, 725, 425 P.3d 837 (2018), and "whether the employer's conduct contravenes the letter … of a … statutory, or regulatory provision." Thompson v. St. Regis Paper Co., 102 Wn.2d 219, 232, 685 P.2d 1081 (1984)?

Issue No. 2 Whether the decision of the Court of Appeals affirming the trial court's denial of leave to amend the complaint to assert an additional source of public policy conflicts with this Court's decision in Ellis v. City of Seattle, 142 Wn.2d 450, 459 n.3, 13 P.3d 1065 (2000), which allowed new sources of public policy to be raised for the first time on appeal?

Issue No. 3 Whether an issue of substantial public interest is involved when the law fails to disincentivize retaliation against whistleblowers who report illegal spending by a publicly-traded company covered up in falsified financial records?

D. Statement of the Case

Petitioners Engstrom and Stockwell were high-level managers at Microsoft. Slip Opinion, at 2. They "became concerned over [Brandon] Yoon's expense reports[,] … believ[ing] that Yoon may have been taking Microsoft clients to … establishments [in Korea] that … provide illegal prostitution services—and expensing illegal prostitution masked as benign meal charges." Id. Once they understood the amounts and nature of the

Korean expenses, Petitioners refused to approve further expense reports and "reported Yoon to Microsoft's Human Resources department," but "assert … that Microsoft continually stymied the investigation." Id. Microsoft, for example, refused requests by its investigators for language services needed to translate Mr. Yoon's handwritten receipts and emails.[3] Stockwell testifies that a Microsoft Human Resources manager "called him at his house and asked him to drop the complaint against Yoon." Slip Opinion, at 2. After the investigation closed with Microsoft finding "no evidence of wrongdoing" by Yoon,[4] Engstrom and Stockwell "assert that the retaliation against them began." Id. at 2-3. Like Dawn Cornwell, the petitioners were no longer valued by Microsoft management, and over a period of many months, their projects were sabotaged, their resources and personnel were withdrawn, they were marginalized, Engstrom was demoted, and both were rated lower and lower until, like Ms. Cornwell, they were rated as "5"s and terminated. See Slip Opinion, at 3; and CP 253-255.[5]

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[3] See CP 1219-20; CP 1118-19; CP 1473 (Sharp describes asking for "Korean translation help"); CP 1224 (Sharp testifies "[t]he big issue here was the language."); and CP 1218 (Sharp admits, "without understanding the Korean language," it was "very hard … to know what the receipts were really for").

[4] Stockwell engaged a Korean translator during the litigation who investigated the same receipts and information Yoon had given Microsoft's investigators. See CP 1835-37. The translator testified about visiting Sonagi—one of the places Yoon expensed—and testified that it "did not look like a restaurant or a place that served food". Id. A man at Sonagi asked the translator, "Can you tell me the pimp's name? Did you book a girl?" Id.

[5] At Microsoft, a 5 rating is the lowest possible rating. Cornwell v. Microsoft Corp., 192 Wn. 2d 403, 408, 430 P.3d 229 (2018).

They sued for wrongful termination in 2015. Slip Opinion, at 4.

In June 2015, the trial court (Judge Sean O'Donnell) granted Microsoft's motion to dismiss under CR 12(b)(6), and Engstrom and Stockwell appealed. Slip Opinion, at 4; CP 215. Microsoft argued in the 2015 motion to dismiss, among other things, that "[t]he **Sarbanes-Oxley Act of 2002** [**SOX**] … **contain[s] provisions to protect FCPA whistleblowers**[,]" CP 40, n.8—leading the trial court to find that "nothing suggests a public policy promoting accurate books and records will be jeopardized if Petitioners are unable to avail themselves of a civil action under state law." CP 217. The trial court in 2015 specifically found that the Petitioners' claim survived the "clarity" analysis, but found that it failed to satisfy the "jeopardy" analysis. CP 1340-1341. In Microsoft's brief responding to the 2015 appeal, it continued to argue that SOX provides adequate protections for FCPA whistleblowers. See, e.g., CP 2131-32, 2138-40 (Resp.'s Brief in 2015) (arguing there are robust "remedies for employees who allege retaliation for reporting suspected FCPA violations, as Engstrom and Stockwell claim"), citing, 18 U.S.C. § 1514A, *et seq*. (SOX).[6]

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[6] There is an SEC rule concerning the books and records provisions of the FCPA that enables persons who report a falsification of corporate "books and records" to have a claim under Sarbanes-Oxley. See Wadler v. Bio-Rad Labs., Inc., 15-CV-02356-JCS, 2017 WL 1910057, at *5 (N.D. Cal. May 10, 2017), affirmed in relevant part, 916 F.3d 1176, 1185 (9th Cir. 2019) ("one of the FCPA books-and-records provisions … is also an SEC regulation within the scope of § 806" of SOX), citing 7 C.F.R. § 240.13b2-1 ("No person shall directly or indirectly, falsify or cause to be falsified, any book, record or

In September 2015, this Court decided Rose v. Anderson Hay and Grain Co., 184 Wn.2d 268, 358 P.3d 1139 (2015), in which it rejected any "analysis into the adequacy of alternative remedies" in favor of reviewing instead "whether a statutory remedy is intended to be exclusive." Id. at 284-285. In light of that decision, Microsoft agreed to a remand. Slip Opinion, at 4.

In September 2017, the trial court (Judge Veronica Galvan) orally granted summary judgment, in part, based on reevaluating the same "clarity" arguments that Microsoft previously made to Judge O'Donnell without success. See RP 23-24 (Judge Galvan's oral ruling that "books and records and accounting provision" are intended to address "whether corporations are … using accounting to cover up bribery of foreign officials," and that there is no "evidence of any bribery of foreign officials" in this case).[7]

Petitioners then moved to amend the Complaint, asking the trial court to consider, as an alternative source of public policy, the whistleblower protection provisions of the Sarbanes-Oxley Act of 2002

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account..."). SEC Rule 13b2–1 was promulgated pursuant to Section 13(b)(2) of the Exchange Act. Exchange Act Release No. 34-15570, 1979 WL 173674, at *5-6 (Appendix 10). See also Becker v. Cmty. Health Sys., Inc., 184 Wn. 2d 252, 264, 359 P.3d 746, 752 (2015) (Fairhurst, dissenting) ("SOX protects persons who disclose information that they reasonably believe constitutes a violation of United States Securities and Exchange Commission (SEC) rules or regulations when the information is provided to 'a person with supervisory authority over the employee (or such other person working for the employer who has the authority to investigate, discover, or terminate misconduct).'"), quoting 18 U.S.C. § 1514A(a)(1)(C).

[7] Compare CP 30-32 (Def.'s 2015 Mot.), with CP 775-776 (Def.'s 2017 Mot.).

("SOX"), 18 U.S.C. § 1514A, *et seq*., which Microsoft had argued in its 2015 briefing provided adequate means to "protect FCPA whistleblowers" like Engstrom and Stockwell. See CP 1025 (Ps.' Mot. for Leave to Amend), citing CP 40, n.8 (Def.'s 2015 Mot. to Dismiss), and CP 217 (Order Granting Motion to Dismiss, entered June 26, 2015, by Judge O'Donnell, ruling that "the Sarbanes-Oxley Act … provide[s] strong protections for FCPA whistleblowers…. 18 U.S.C. § 1514A").

Judge Galvan denied Petitioners' motion for leave to amend the complaint, CP 1961, and eight days later, on October 19, 2017, entered the order granting defendant's motion for summary judgment. CP 1963.

The Court of Appeals affirmed both decisions. The Court of Appeals affirmed dismissal of the case based on finding that Appellants "failed to meet their burden to plead and prove that a stated public policy, either legislatively or judicially recognized, may have been contravened." Slip Opinion, at 12. The Court wrote that "our Supreme Court has previously stated that 'the [FCPA] is a clear expression of public policy that bribery of foreign officials is contrary to the public interest,'' id., at 8, quoting Thompson,102 Wn.2d at 234, and it reasoned that because "Engstrom and Stockwell do not allege anything related to the bribery of foreign officials[,] … the FCPA's public policy was not implicated[.]" Id. The Court also ruled that the proposed amendment was the result of undue delay, futile, and would have prejudiced Microsoft. Slip Opinion, at 10-12.

E. Argument Why Review Should Be Accepted

1. The Appellate Decision Regarding Petitioners' Wrongful Discharge Claim Conflicts With This Court's Decision In *Thompson* and Its Progeny

The Court should grant review under RAP 13.4(b)(1). The Court of Appeals held that reporting concerns that a publicly-traded company like Microsoft "masking" illegal prostitution "as benign meal charges" in its corporate financial books does not implicate a clear public policy—despite recognizing that the "books-and-records" provision of the FCPA requires publicly-traded companies 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 [securities] issuer." See Slip Opinion, at 2 and 8-9, quoting 15 U.S.C. § 78m(b)(2)(A).

The Court of Appeals' holding conflicts with this Court's decision in Thompson v. St. Regis Paper Co., 102 Wn.2d 219, 685 P.2d 1081 (1984). In Thompson, the Court declared, "to state a cause of action, the employee must plead and prove that a stated **public policy**, **either legislatively or judicially recognized**, may have been contravened." Id., at 232. The Court has consistently reaffirmed this rule in subsequent cases. See, e.g., Rose, 184 Wn.2d at 275; Martin, 191 Wn.2d at 725 (stating that "[t]he question of what constitutes a clear mandate of public policy … can be established by … statutory, or regulatory provisions"); and Smith v. Bates Tech. Coll., 139 Wn. 2d 793, 807, 991 P.2d 1135 (2000) ("When

determining whether a clear mandate of public policy is violated, we consider "'whether the employer's conduct contravenes the letter … of a … statutory, or regulatory provision'"), quoting Thompson, 102 Wn.2d at 232.

In this case, the Court of Appeals departed from the inquiry required by Thompson. The primary question to be asked under Thompson is whether the Petitioners' whistleblowing addresses a violation of the employer's duties grounded in statute or regulation. Engstrom and Stockwell's whistleblowing unquestionably does.

Petitioners allege they were fired for reporting that a Microsoft employee falsified financial records to cover up illegal spending of shareholder monies, in violation of 15 U.S.C. § 78m(b)(2)(A). This law, the books-and-records provision of the FCPA, is an amendment to the Securities and Exchange Act of 1934, Pub. L. No. 95-231, 91 Stat. 1495 (1977) (Appendix 7). For that reason, the law is also referred to as "**Section 13(b)(2)(A) of the Exchange Act**."[8]

It is undisputed that "bribery of a foreign official" is not necessary to violate 15 U.S.C. § 78m(b)(2)(A). See, e.g., In re Microsoft Corp., S.E.C. Admin Proceeding File No. 3-10789 (June 3, 2002) (Appendix 6), at 8-9; see also S.E.C. v. World-Wide Coin Investments, Ltd., 567 F.Supp.

[8] In re Microsoft Corp., S.E.C. Admin Proceeding File No. 3-10789 (June 3, 2002) (Appendix 6), at 8-9.

724, 747-48, n.40 (N.D. Ga. 1983); see also Stuart Deming, *The Potent and Broad-Ranging Implications of the Accounting and Record-Keeping Provisions of the Foreign Corrupt Practices Act*, 96 J. Crim. L. & Criminology 465, 467-68 (2006) (Appendix 12) (hereinafter, "Deming, The Potent and Broad-Ranging FCPA Accounting Provisions"); and D. Goelzer, *The Accounting Provisions of the FCPA—The Federalization of Corporate Recordkeeping and Internal Control*, 5 J.Corp.L. 1, 4 (1979) (Appendix 11) ("despite their common ancestry, the accounting provisions are much broader than the antibribery sections" of the FCPA).

Microsoft admits that the FCPA requires it "to keep accurate books about what [its] expenses are actually made for" and to "truthfully represent what the expense is." See CP 1106-1107.[9] Petitioners' wrongful discharge claim is therefore premised on reporting a violation of Microsoft's duty to keep accurate books-and-records, a legal obligation and public policy that is "legislatively recognized." This satisfies the criteria for proving "clarity" described in Thompson and its progeny. See 102 Wn.2d at 232. The Court of Appeals' holding, finding that Petitioners

[9] The scope of the books-and-records provision extends to "virtually any tangible embodiment of information made or kept by an issuer." World-Wide Coin, 567 F.Supp. at 748–49. Accord In re Microsoft Corp. (Appendix 6) at 9 ("A company's 'books and records' include not only general ledgers and accounting entries, but also memoranda and internal corporate reports."). "Manipulating an entity's books or records to mask transactions by characterizing them in some oblique way, or by actually falsifying a transaction, can lead to serious exposure for an issuer and those individuals involved. For example, placing a transaction into an abnormal category or 'burying' it in some other way could serve as a basis for an enforcement action for a violation of Rule 13b2-1." Deming, The Potent and Broad-Ranging FCPA Accounting Provisions, at 487-88.

failed to satisfy the clarity element, is irreconcilable with the rule outlined in Thompson.

This Court should grant review to provide guidance to the lower courts to prevent further misunderstanding on how "the employee must plead and prove that a stated public policy, either legislatively or judicially recognized, may have been contravened." Thompson, 102 Wn.2d at 232.

2. The Appellate Decision Regarding Petitioners' Wrongful Discharge Claim Conflicts With This Court's Decision In *Ellis*

The Court of Appeals affirmed the trial court's denial of Petitioners' motion for leave to amend the complaint based, in part, on finding that Petitioners "unduly delayed" pleading SOX's whistleblower provision, 18 U.S.C. § 1514A, *et seq*., as an additional source of public policy. See Slip Opinion at 9-11.

This Court has previously held that additional sources of public policy may be raised for the first time on appeal. Ellis v. City of Seattle, 142 Wn.2d 450, 459, n.3, 13 P.3d 1065 (2000) ("There is no requirement to list every statute, code, or case brought to the attention of the trial court. Nor should there be, as any court is entitled to consult the law in its review of an issue, whether or not a party has cited that law"). For such reason, the appellate decision conflicts with Ellis to the extent that it restrains a plaintiff's ability to rely on a statute or code owing to consideration of whether the law was timely pleaded in the trial court.

In this case, Petitioners moved to amend the complaint after they discovered at oral argument in 2017 that Judge Galvan, in contrast to Judge O'Donnell in 2015, would not accept the FCPA as a mandate of clear public policy supporting their claim.[10] Petitioners promptly sought leave to plead SOX's whistleblower provisions as an alternative source of public policy before the Order on Summary Judgment was entered.[11] Neither the trial court nor Microsoft articulated any prejudice, and how could they since Microsoft, in seeking dismissal based on jeopardy in 2015, injected SOX's protection of "FCPA whistleblowers" into the case, see CP 40, n.8; and the elements of the claim remained unchanged. See Kirkham v. Smith, 106 Wn. App. 177, 181, 23 P.3d 10 (2001); and footnote 6, *supra* (describing how reporting falsified books-and-records in violation of the FCPA is one type of protected reporting under SOX).

The Court should grant review under RAP 13.4(b)(1) to avoid confusion by the lower courts and to provide guidance as to whether the courts are able to consider additional sources of public policy, even when presented for the first time on appeal, as the Court held in Ellis.

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[10] See CP 1059-61; CP 1024-1036.

[11] Id.; CP 1962, 1965.

3. The Failure to Protect Whistleblowers Who Report Illegal Spending Being Covered Up in Falsified Corporate Financial Records Is An Issue Of Substantial Public Interest

The Court should also grant review under RAP 13.4(b)(4). Incentivizing of whistleblowing about illegal corporate spending and disincentivizing retaliation for whistleblowing concerning illegal corporate spending are matters of substantial public interest.

The FCPA's accounting provisions derive from the "work of the Office of the Watergate Special Prosecutor, [which made] the [Securities and Exchange] Commission … aware of a pattern of conduct involving the use of corporate funds for illegal domestic political contributions." Promotion of Reliability of Financial Information & Prevention of the Concealment of Questionable or Illegal Corp. Payments & Practices, Securities Exchange Act Release No. 34-15570, 1979 WL 173674 (SEC), at *2 (Feb. 15, 1979) (Appendix 10) (hereinafter, "Exchange Act Release No. 34-15570"). "Subsequent Commission investigations revealed that instances of undisclosed questionable or illegal corporate payments—both domestic and foreign—were indeed widespread and represented a serious breach in both the operation of the Commission's system of corporate disclosure and, correspondingly, in public confidence in the integrity of the system of capital formation." Id.

Whistleblowers who are "company insiders," like the Petitioners, are critical to the detection of corporate misconduct and crimes, as they are often the only people who can give investigators a roadmap to uncover misconduct that is otherwise "hard to spot."[12] At the same, "[w]histleblowers who report suspicions … are usually in a vulnerable position" and are "subject to pressures to remain silent with threats of … loss of employment."[13]

"The central idea of the public policy tort is to create privately enforceable disincentives for ... employers to use their power in the workplace to undermine important public policies." Henry H. Perritt, Jr., Employee Dismissal Law and Practice § 7.06[A], at 7–82.3 (Supp.2013), quoted in Becker v. Cmty. Health Sys., Inc., 182 Wn. App. 935, 951, 332 P.3d 1085 (2014), aff'd, 184 Wn. 2d 252, 359 P.3d 746 (2015). Such disincentives are now lacking to stop corporations from retaliating against employees who report illegal spending being covered up in corporate books and records.

The Court of Appeals has denied a remedy to whistleblowers claiming retaliation for reporting the concern that Microsoft's employee

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[12] See Andrew Ceresney, The SEC's Whistleblower Program: The Successful Early Years, Speech at the Sixteenth Annual Taxpayers Against Fraud Conference (Sept. 14, 2016) (transcript available at https://www.sec.gov/news/speech/ceresney-sec-whistleblower-program.html).

[13] Vishal Marria, How Important Are Whistleblowers in Detecting Crime and Fraud, FORBES (Nov. 2, 2018), https://www.forbes.com/sites/vishalmarria/2018/11/02/how-important-are-whistleblowers-in-detecting-crime-and-fraud/.

was "expensing illegal prostitution masked [in Microsoft's books] as benign meal charges." See Slip Opinion, at 2-3.[14] The law must protect persons like Engstrom and Stockwell who in good faith and at great risk report illegal spending being covered up through falsified corporate financial records.

In enacting the FCPA's accounting provisions, Congress reported that the law was intended to "assure… that the [corporation's] assets are used for proper corporate purpose[s]." S. REP. NO. 95-114 (1977) (Appendix 9), at 7. In implementing the FCPA, the SEC similarly recognized that an important objective of the law is "the goal of corporate accountability."[15] "[C]orporate officials are unlikely to engage in questionable or illegal conduct and simultaneously reflect it accurately on corporate books and records." Report of the Securities and Exchange Commission on Questionable and Illegal Corporate Payments and Practices, submitted to Comm. on Banking, House and Urban Affairs, United States Senate (May 12, 1976) (hereinafter "SEC Questionable Payments Report"), at 42 (Appendix 8).

"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

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[14] Accord CP 1216-17 (allegations involved spending on "infamous hostess bars" where you pay for sex); and CP 1363 (concern involved Yoon "falsifying expenses").

[15] Exchange Act Release No. 34-15570, 1979 WL 173674 at * 6 (Appendix 10).

corporations will account for their funds properly and will not 'launder' … 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." Id., at 58.

Thus, the FCPA's accounting provisions were developed "to address management misfeasance, misuse of corporate assets and other conduct reflecting adversely on management's integrity," and they make "misrepresentation, concealment, falsification, circumvention, and other deliberate acts resulting in inaccurate financial books and records … unlawful." World-Wide Coin, 567 F.Supp. at 748.

"The establishment and maintenance of … accurate books and records are fundamental responsibilities of management. The expected benefits to be derived from the conscientious discharge of these responsibilities are of basic importance to investors and the maintenance of the integrity of our capital market system." S. REP. NO. 95-114, at 8; accord World–Wide Coin, 567 F.Supp. at 746 ("The FCPA was enacted on the principle that accurate recordkeeping is an essential ingredient in promoting management responsibility and is an affirmative requirement for publicly held American corporations to strengthen the accuracy of corporate books and records, which are 'the bedrock elements of our system of corporate disclosure and accountability.'"); and S. REP. NO. 95-

114, at 7 ("the accuracy of the corporate books and records and the reliability of the audit process … constitute the foundations of our system of corporate disclosure"). See also Remarks of Senator Harrison Williams (Co-sponsor of Bill), 123 Cong.Rec. 519, 400 (Daily Ed. Dec. 6, 1977) ("The accounting sections of the bill… reach beyond the problem of bribery and other questionable payments … [They] will prevent defiance or circumvention of the system of corporate accountability, assure reliable and accurate books and records, protect the integrity of the audit process and make clear the responsibilities of corporate management and accountants, and safeguard fundamental precepts of corporate democracy."), quoted in D. Goelzer, *The Accounting Provisions of the FCPA—The Federalization of Corporate Recordkeeping and Internal Control*, 5 J.Corp.L. 1, 11 (1979) (Appendix 11). "Public confidence in securities markets [is] enhanced by assurance that corporate recordkeeping is honest." S. REP. NO. 95-114, at 7.

> The SEC report proposing the legislation concerning accounting and recordkeeping practices, which was in large part ultimately adopted as part of the FCPA, stated that questionable payments 'cast doubt on the integrity and reliability of the corporate books and records which are the very foundation for the disclosure system established by the federal securities laws.' The report went on to state that '[i]mplicit 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 systems administered by the SEC.'

Deming, The Potent and Broad-Ranging FCPA Accounting Provisions, at 469-70, quoting SEC Questionable Payments Report, at 3 and 48-49.

Ensuring that publicly-traded companies accurately record all of their financial transactions in corporate books and records "protect[s] the investor" and the investing the public. See World-Wide Coin., 567 F.Supp. at 746, citing SEC Questionable Payments Report, at 58.

In Becker, the case of another SOX whistleblower, the Court of Appeals recognized the "impact of chilling … employee conduct advocating compliance with statutes and regulations," and ruled that the wrongful discharge tort's coexistence with other enforcement mechanisms is "essential" to not jeopardize the public policy of honesty in financial reporting. See 182 Wn. App. at 947 and 951. It is similarly essential to the public policy that employees like Engstrom and Stockwell, who report "[f]alsification" of expenses used to cover up illegal spending by the corporation, see CP 1363, accord Slip Opinion, at 2-3, have a private tort remedy to disincentivize corporations from undermining the public policy.

F. Conclusion

For all of reasons stated herein, Petitioners respectfully request that this Court grant review of the decision of the court below.

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DATED this 11th day of July, 2019.

THE SHERIDAN LAW FIRM, P.S.

By: s/ John P. Sheridan

John P. Sheridan, WSBA # 21473
Mark Rose, WSBA# 41916

Attorneys for Petitioners

DECLARATION OF SERVICE

Mark Rose states and declares that on the below date, I served a copy of the foregoing pleading on the following attorneys via the Court's e-filing application:

Robert J. Maguire
Melissa Mordy
Arthur Simpson
DAVIS WRIGHT TREMAINE LLP
1201 Third Avenue, Suite 2200
Seattle, WA 98101
robmaguire@dwt.com
missymordy@dwt.com
arthursimpson@dwt.com

I declare under penalty of perjury under the laws of the State of Washington that the foregoing is true and correct.

DATED this 11th day of July, 2019, at Seattle, Washington.

s/Mark Rose
Mark Rose, WSBA #41916

APPENDICES

1.	Engstrom v. Microsoft Corp., No. 77538-3-I (Wash. Ct. App. May 6, 2019) (“Slip Opinion”)
2.	Order Denying Motion for Reconsideration (Wash. Ct. App. June 11, 2019)
3.	15 U.S.C. § 78m(b)(2)(A)
4.	18 U.S.C. § 1514A, *et seq.*
5.	17 C.F.R. § 240.13b2-1
6.	In re Microsoft Corp., S.E.C. Admin. Proceeding File No. 3-10789 (June 3, 2002)
7.	Pub. L. No. 95-231, 91 Stat. 1495 (1977) – *excerpted*
8.	Report of the Securities and Exchange Commission on Questionable and Illegal Corporate Payments and Practices, submitted to Comm. on Banking, House and Urban Affairs, United States Senate (May 12, 1976) – *excerpted*
9.	S. REP. NO. 95-114 (1977) - *excerpted*
10.	Promotion of Reliability of Financial Information & Prevention of the Concealment of Questionable or Illegal Corp. Payments & Practices, Securities Exchange Act Release No. 34-15570 (Feb. 15, 1979)
11.	D. Goelzer, *The Accounting Provisions of the FCPA—The Federalization of Corporate Recordkeeping and Internal Control*, 5 J.Corp.L. 1 (1979) – *excerpted*
12.	Stuart Deming, *The Potent and Broad-Ranging Implications of the Accounting and Record- Keeping Provisions of the Foreign Corrupt Practices Act*, 96 J. Crim. L. & Criminology, 465 (2006) – *excerpted*

APPENDIX 1

FILED
5/6/2019
Court of Appeals
Division I
State of Washington

IN THE COURT OF APPEALS OF THE STATE OF WASHINGTON

GEORGE E. ENGSTROM and JOHN E. STOCKWELL,	No. 77538-3-I
Appellants,	DIVISION ONE
v.	
MICROSOFT CORPORATION,	UNPUBLISHED OPINION
Respondent.	FILED: May 6, 2019

MANN, A.C.J. — George Engstrom and John Stockwell appeal the trial court's summary judgment dismissal of their claim for wrongful discharge in violation of public policy against Microsoft Corporation. They believe that they were terminated from Microsoft as retaliation for initiating an investigation into another Microsoft employee. Because Engstrom and Stockwell failed to meet their burden to plead and prove that a stated public policy, either legislatively or judicially recognized, may have been contravened, dismissal of their claim for wrongful discharge in violation of public policy was appropriate. We affirm.

I.

Engstrom and Stockwell were high level managers within Microsoft's Online Services Division. In late 2010, Engstrom and Stockwell began working with Brandon Yoon, a lower level Microsoft employee. Yoon was tasked with acting as a liaison between LG Uplus—a Korean cell phone carrier—and Microsoft on a deal that Engstrom and Stockwell were supervising.

In early 2011, Stockwell and Engstrom became concerned over Yoon's expense reports. They believed that Yoon may have been taking Microsoft clients to "hostess bars"—establishments that employ women to provide men with companionship, some of which also provide illegal prostitution services—and expensing illegal prostitution masked as benign meal charges. After confronting Yoon about their concerns, which he denied, Stockwell and Engstrom reported Yoon to Microsoft's Human Resources department.

In response, Microsoft's Office of Legal Compliance (OLC) opened an investigation into Yoon's expense reports. Engstrom and Stockwell assert, however, that Microsoft continually stymied the investigation. They allege that Microsoft refused to devote sufficient assets to properly investigate their allegations, and did not have a Korean language translator look at the various receipts that Yoon had submitted for reimbursement. While this investigation was ongoing, Yoon transferred out of Engstrom and Stockwell's work group with the help of Corporate Vice President Harry Shum. Further, Stockwell asserts that Jeff Williams, a Microsoft Human Resources manager, called him at his house and asked him to drop the complaint against Yoon. Ultimately, the OLC concluded that there was no evidence of wrongdoing.

After the investigation was closed, Engstrom and Stockwell assert that the retaliation against them began. Engstrom and Stockwell believe that Yoon was the protégé of Harry Shum, who told his good friends, President of Online Services Division Qi Lu and Corporate Vice President David Ku, to retaliate against Engstrom and Stockwell. For example, Engstrom and Stockwell were transferred to other working groups at Microsoft soon after the investigation closed. Engstrom was almost demoted by Qi Lu but was able to gain temporary protection after e-mailing Microsoft CEO Steve Ballmer. Engstrom was later demoted by David Ku. Similarly, Stockwell believed that he was taken off of a potentially lucrative project only after the manager of the project spoke to Qi Lu about Stockwell. Both Engstrom and Stockwell also believe that they received unwarranted negative performance reviews as retaliation for reporting Yoon.

In May 2013, Corporate Vice President David Ku notified the 80 Microsoft employees involved with two projects—"Triani" and "Slice"—that both projects were cancelled. Engstrom and Stockwell were both members of those projects. Ku told the employees that they should try to find alternative employment arrangements within Microsoft. Those employees continued to get paid by Microsoft while trying to find suitable employment. All but 4 of the 80 affected employees were able to find alternative employment within Microsoft. Neither Engstrom nor Stockwell found alternative employment.

In October 2013, Ku prepared a business justification memorandum for a selective reduction in force for the four employees who had not yet found alternative employment: Engstrom, Stockwell, Yarom Boss, and Jeffrey Robinson. In December 2013, Ku terminated Stockwell and Boss as part of the reduction in force. Robinson

was not terminated because he was able to find alternative employment at the last minute. Engstrom was not terminated until January 2014 because he was on paternity leave at the time. Ku allowed Engstrom to return from paternity leave and allowed $335,000 worth of Engstrom's stock options to vest before terminating him.

On February 25, 2015, Engstrom and Stockwell sued Microsoft alleging that it had wrongfully discharge them in violation of public policy. In June 2015, the trial court granted Microsoft's motion to dismiss, and Engstrom and Stockwell appealed. In September 2015, while that appeal was pending, Microsoft agreed to a voluntary remand in light of three recently decided Supreme Court cases.[1] See Engstrom v. Microsoft Corp., No. 74200-1-I (Wash. Ct. App. Feb. 16, 2016) (unpublished) (per curiam). For the next two years the parties engaged in extensive discovery. After discovery closed Microsoft moved for summary judgment, which the trial court orally granted on September 25, 2017.

A week later, Engstrom and Stockwell moved for leave to amend their complaint to assert a new source of public policy under the Sarbanes-Oxley Act, 18 U.S.C. § 1514A(d). The trial court denied the motion because it found that the Engstrom and Stockwell had unduly delayed bringing the motion, the amendment would be futile, and Microsoft would be unduly prejudiced by the amendment. Engstrom and Stockwell then unsuccessfully moved for reconsideration. Engstrom and Stockwell appeal.

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[1] Rose v. Anderson Hay and Grain Co., 184 Wn.2d 268, 358 P.3d 1139 (2015); Becker v. Community Health Systems, Inc., 184 Wn.2d 252, 359 P.3d 746 (2015); and Rickman v. Premera Blue Cross, 184 Wn.2d 300, 358 P.3d 1153 (2015).

II.

We review a trial court's grant of summary judgment de novo. Camicia v. Howard S. Wright Constr. Co., 179 Wn.2d 684, 693, 317 P.3d 987 (2014). Summary judgment is appropriate only when there is no genuine issue as to any material fact and the moving party is entitled to judgment as a matter of law. CR 56(c). When making this determination, we consider all facts and make all reasonable factual inferences in the light most favorable to the nonmoving party. Young v. Key Pharms., Inc., 112 Wn.2d 216, 226, 770 P.2d 182 (1989).

A.

The Washington Supreme Court first recognized the wrongful discharge in violation of public policy tort in Thompson v. St. Regis Paper Co., 102 Wn.2d 219, 232, 685 P.2d 1081 (1984). There, the court described the tort as a narrow exception to the at will employment doctrine. "[T]o state a cause of action, the employee must plead and prove that a stated public policy, either legislatively or judicially recognized, may have been contravened." Thompson, 102 Wn.2d at 232. "[T]he burden shifts to the employer to prove that the dismissal was for reasons other than those alleged by the employee." Thompson, 102 Wn.2d at 232-33. In Gardner v. Loomis Armored, Inc., the Supreme Court clarified that there are four situations when the tort is recognized:

> (1) where employees are fired for refusing to commit an illegal act; (2) where employees are fired for performing a public duty or obligation, such as serving jury duty; (3) where employees are fired for exercising a legal right or privilege, such as filing workers' compensation claims; and (4) where employees are fired in retaliation for reporting employer misconduct, i.e., whistleblowing.

128 Wn.2d 931, 936, 913 P.2d 377 (1996).

When the employee's case "does not fit neatly within one of these [four] scenarios . . . a more refined analysis may be necessary, and the four-factor Perritt analysis may provide helpful guidance." Becker v. Community Health Systems, Inc., 184 Wn.2d 252, 259, 359 P.3d 746 (2015) (citing HENRY H. PERRITT, JR., WORKPLACE TORTS: RIGHTS AND LIABILITIES, § 3.7 (1991) (hereinafter Perritt). To meet their burden of proof under the Perritt test, a plaintiff must show: (1) the existence of a clear public policy (the clarity element), (2) that discouraging the conduct in which the plaintiff engaged would jeopardize the public policy (the jeopardy element), (3) that the public-policy-linked conduct caused the dismissal (the causation element), and (4) that the defendant has not offered an overriding justification for the dismissal of the plaintiff (the absence of justification element). Gardner, 128 Wn.2d at 941; Martin v. Gonzaga University, 191 Wn.2d 712, 723, 425 P.3d 837 (2018).

B.

As a preliminary matter, Engstrom and Stockwell assert that the Perritt test does not apply because they are whistleblowers. Microsoft disagrees and argues that Engstrom and Stockwell are not whistleblowers because they only raised concerns about an employee's expense records, they did not complain that their employer, Microsoft, had committed misconduct.

Viewed in the light most favorable to Engstrom and Stockwell, we assume without deciding that they are whistleblowers and thus fit within the scope of Gardner. But regardless of whether Engstrom's and Stockwell's actions constituted whistleblowing, they must still demonstrate that their discharge may have been motivated by actions that contravene a clear expression of public policy. See, e.g.,

Martin, 191 Wn.2d at 724-25 (When the appellant's claim is based on whistle-blowing he still "has the burden to show that his discharge may have been motivated by reasons that contravene a clear mandate of public policy.").[2]

To meet their burden, Engstrom and Stockwell were required to "plead and prove that a stated public policy, either legislatively or judicially recognized, may have been contravened." Thompson, 102 Wn.2d at 232; Martin, 191 Wn.2d at 725. In Thompson, the Supreme Court "embraced a burden-shifting analysis in which the analytical focus was whether the employee could establish that the discharge clearly contravened public policy." Rose, 184 Wn.2d at 275 (citing Thompson, 1102 Wn.2d at 232-33). And while Gardner "refined the tort's analytical framework somewhat [the Supreme Court] expressly refrained from substantively changing the underlying tort requirements." Rose, 184 Wn.2d at 277. "[T]he tort [remains] a narrow exception to the at-will doctrine and must be limited only to instances involving very clear violations of public policy." Rose, 184 Wn.2d at 276.

"'The question of what constitutes a clear mandate of public policy is one of law and can be established by prior judicial decisions or constitutional, statutory, or regulatory provisions or schemes." Martin, 191 Wn.2d at 725 (quoting Dicomes v. State, 113 Wn.2d 612, 617, 782 P.2d 1002 (1989)). "A court may not sua sponte manufacture public policy but rather must rely on that public policy previously manifested in the constitution, a statute, or a prior court decision." Rickman v. Premera Blue Cross, 184 Wn.2d 300, 310, 358 P.3d 1153 (2015).

[2] Counsel for Engstrom and Stockwell agreed at oral argument.

Engstrom and Stockwell rely on the Foreign Corrupt Practices Act of 1977, 15 U.S.C. § 78m (FCPA), to demonstrate that there is a clearly established public policy against falsifying corporate records or books. The FCPA makes it illegal for corporations to bribe foreign officials. 15 U.S.C. § 78dd-1(a)(1) ("It shall be unlawful for any [publically traded corporation to] . . . pay[], promise to pay, or authoriz[e] . . . payment of any money . . . [to] any foreign official for purposes of . . . influencing any act or decision . . . or inducing such foreign official to use his influence" to favor the corporation). The FCPA also contains a books and records provision, which requires corporations 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." 15 U.S.C. § 78m(b)(2)(A).

Engstrom and Stockwell assert that the books and records provision of the FCPA established a second public policy beyond just prohibiting the bribery of foreign officials. But contrary to their argument, our Supreme Court has previously stated that "the [FCPA] is a clear expression of public policy that bribery of foreign officials is contrary to the public interest and that specific companies . . . must institute accounting practices to ensure that this public policy is advanced." Thompson, 102 Wn.2d at 234.[3] See also S. REP. NO. 95-114, at 3, 7 ("Taken together, the accounting requirements and [bribery] prohibitions of [the FCPA] should effectively deter corporate bribery of foreign government officials. . . . The accounting standards . . . are intended to operate in

[3] See also Sedlacek v. Hillis, 145 Wn.2d 379, 386, 36 P.3d 1014 (2001) (the FCPA is "a clear expression of public policy in favor of careful accounting to prevent bribery of foreign officials."); Danny v. Laidlaw Trans. Servs. Inc., 165 Wn.2d 200, 219-20, 193 P.3d 128 (2008) (the FCPA's public policy is to "prohibit[] bribery of foreign officials.").

tandem with the [antibribery provisions] . . . to deter corporate bribery."), reprinted in 1977 U.S.C.C.A.N. 4098, 4100, 4104.

Engstrom and Stockwell further argue that because the FCPA makes it illegal to falsify corporate books or records, the Supreme Court's language in Thompson, that courts should "inquire whether the employer's conduct contravenes the letter or purpose of a constitutional, statutory, or regulatory provision or scheme[,]" indicates that the clear public policy element is met here. 102 Wn.2d at 232. But, contrary to the appellants' assertion, this language was intended to indicate that the asserted public policy must be clear. The quote continues: "courts should proceed cautiously if called upon to declare public policy absent some prior legislative or judicial expression on the subject." Thompson, 102 Wn.2d at 232 (citing Parnar v. Americana Hotels, Inc., 65 Hawaii 370, 652 P.2d 625 (1982)).

Engstrom and Stockwell do not allege anything related to the bribery of foreign officials. Rather, they allege that they were discharged for internally reporting a subordinate's expense reports. Because the FCPA's public policy was not implicated here, Engstrom and Stockwell failed to meet their initial burden to demonstrate a prima facie case for wrongful discharge in violation of public policy.

III.

Lastly, Engstrom and Stockwell contend that the trial court abused its discretion in denying their motion to amend their complaint to include a second public policy under the Sarbanes-Oxley Act, 18 U.S.C. § 1514A, et seq. We disagree.

This court reviews a trial court's denial of a motion to amend a complaint for an abuse of discretion. Shelton v. Azar Inc., 90 Wn. App. 923, 928, 954 P.2d 352 (1998).

The burden of proving an abuse of discretion has occurred "rests upon the challenging party." Duckworth v. City of Bonney Lake, 91 Wn.2d 19, 34, 586 P.2d 860 (1978).

"[A] party may amend the party's pleadings only by leave of court or by written consent of the adverse party; and leave shall be freely given when justice so requires." CR 15(a). "If the underlying facts or circumstances relied upon by a plaintiff may be a proper subject of relief, he ought to be afforded an opportunity to test his claim on the merits." Tagliani v. Colwell, 10 Wn. App. 227, 233, 517 P.2d 207 (quoting Foman v. Davis, 371 U.S. 178, 182, 83 S. Ct. 227, 9 L. Ed. 2d 222 (1962)). But it is within the trial court's discretion to deny a motion to amend if there was an undue delay in bringing the motion, if it would result in undue prejudice to the opposing party, or if the amendment would be futile. Tagliani, 10 Wn. App. at 233 (quoting Foman, 371 U.S. at 182).

The trial court did not abuse its discretion in denying Engstrom and Stockwell's motion to amend. First, Engstrom and Stockwell unduly delayed in bringing their motion. The motion for leave to amend was filed over two years after the initial complaint and a week after the trial court orally granted Microsoft's motion for summary judgment. The basis for the requested motion was to reference the "public policy of honesty in corporate financial reporting" recognized in Becker v. Community Health Systems, Inc, 184 Wn.2d 252, 359 P.3d 746 (2015), and to allege a second public policy under the whistleblower protection provisions of the Sarbanes-Oxley Act.

Although Becker was decided after Engstrom and Stockwell filed their initial action, Becker was one of the trio of cases that resulted in the voluntary remand of the initial appeal. See Engstrom v. Microsoft Corp., No. 74200-1-I (Wash. Ct. App. Feb. 16, 2016) (unpublished) (per curiam). Had Engstrom and Stockwell wished to amend their

complaint to include the desired references in Becker, they had the perfect opportunity to do so after the initial remand and before beginning discovery. But to neglect that motion until after discovery had been completed and the trial court orally granted the respondent's motion for summary judgment was an undue delay.

Second, the motion to amend was futile. Shelton v. Azar, Inc., 90 Wn. App 923, 928, 954 P.2d 352 (1998) (trial court abused discretion in granting leave to amend where the amendment was futile). The proposed amendment would have been futile because the policies behind the whistleblower protections of the Sarbanes-Oxley Act do not apply here. Section 1514A of Sarbanes-Oxley provides protection to employees of publically traded corporations if they provided information to or otherwise assisted in an investigation. 18 U.S.C. § 1514A(a). Under Sarbanes-Oxley, a plaintiff must establish that he or she engaged in protected activity and the activity must relate to securities fraud. Sarbanes-Oxley is intended to protect employees who report "'fraudulent activity that can damage innocent investors'" and "'to provide federal protection to private corporate whistleblowers.'" Day v. Staples, Inc., 555 F.3d 42, 52 (1st Cir. 2009) (quoting S. Rep. No. 107-146, at 19 (2002); Carnero v. Boston Sci. Corp., 433 F.3d 1, 11 (1st Cir. 2006)). A single employee's misuse of expense reports, even if a violation of company policy, does not rise to the level of securities fraud that Sarbanes-Oxley was intended to address.

Similarly, in Becker, the plaintiff was the defendant's Chief Financial Officer and he claimed he refused to publicly misrepresent the company's operating losses in public filings and that he was constructively discharged for his insubordination. Becker, 184 Wn.2d at 255-56. This is different from Engstrom and Stockwell, whose expense

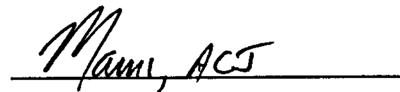
concerns involved internal expense reports by a subordinate, not Microsoft's public financial reports.

Finally, the trial court did not abuse its discretion in denying the motion to amend due to the prejudice it would cause Microsoft. Engstrom and Stockwell had the requisite knowledge and opportunity to amend their complaint shortly after its initial filing. Granting this motion would have essentially forced the parties to reopen discovery and dispositive motions, more than two years into the litigation. See Evergreen Moneysource Mortgage Co. v. Shannon, 167 Wn. App. 242, 262-63, 274 P.3d 375 (2012) (no abuse of discretion to deny motion to amend where nonmoving parties would be required to complete additional discovery and repeat already conducted discovery).

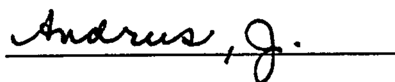
The trial court did not abuse its discretion in denying Engstrom and Stockwell's motion for leave to amend.

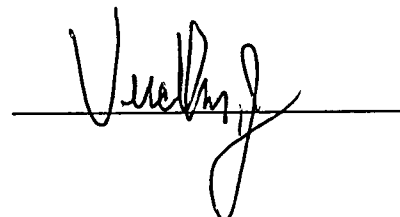
Because Engstrom and Stockwell failed to meet their burden to plead and prove that a stated public policy, either legislatively or judicially recognized, may have been contravened, dismissal of their claim for wrongful discharge in violation of public policy was appropriate.

We affirm.



WE CONCUR:





APPENDIX 2

FILED
6/11/2019
Court of Appeals
Division I
State of Washington

IN THE COURT OF APPEALS OF THE STATE OF WASHINGTON

GEORGE E. ENGSTROM and JOHN E. STOCKWELL, Appellants, v. MICROSOFT CORPORATION, Respondent.	No. 77538-3-I DIVISION ONE ORDER DENYING MOTION FOR RECONSIDERATION

Appellants George Engstrom and John Stockwell filed a motion for reconsideration of the court's opinion filed on May 6, 2019. The panel has determined that the motion for reconsideration should be denied.

Therefore, it is

ORDERED that the motion for reconsideration is denied.

FOR THE PANEL:

Mann, A.C.J.

APPENDIX 3

United States Code Annotated
Title 15. Commerce and Trade
Chapter 2B. Securities Exchanges (Refs & Annos)

15 U.S.C.A. § 78m

§ 78m. Periodical and other reports

Effective: August 10, 2012
Currentness

(a) Reports by issuer of security; contents

Every issuer of a security registered pursuant to section 78*l* of this title shall file with the Commission, in accordance with such rules and regulations as the Commission may prescribe as necessary or appropriate for the proper protection of investors and to insure fair dealing in the security--

(1) such information and documents (and such copies thereof) as the Commission shall require to keep reasonably current the information and documents required to be included in or filed with an application or registration statement filed pursuant to section 78*l* of this title, except that the Commission may not require the filing of any material contract wholly executed before July 1, 1962.

(2) such annual reports (and such copies thereof), certified if required by the rules and regulations of the Commission by independent public accountants, and such quarterly reports (and such copies thereof), as the Commission may prescribe.

Every issuer of a security registered on a national securities exchange shall also file a duplicate original of such information, documents, and reports with the exchange. In any registration statement, periodic report, or other reports to be filed with the Commission, an emerging growth company need not present selected financial data in accordance with section 229.301 of title 17, Code of Federal Regulations, for any period prior to the earliest audited period presented in connection with its first registration statement that became effective under this chapter or the Securities Act of 1933 and, with respect to any such statement or reports, an emerging growth company may not be required to comply with any new or revised financial accounting standard until such date that a company that is not an issuer (as defined under section 7201 of this title)

is required to comply with such new or revised accounting standard, if such standard applies to companies that are not issuers.

(b) Form of report; books, records, and internal accounting; directives

(1) The Commission may prescribe, in regard to reports made pursuant to this chapter, the form or forms in which the required information shall be set forth, the items or details to be shown in the balance sheet and the earnings statement, and the methods to be followed in the preparation of reports, in the appraisal or valuation of assets and liabilities, in the determination of depreciation and depletion, in the differentiation of recurring and nonrecurring income, in the differentiation of investment and operating income, and in the preparation, where the Commission deems it necessary or desirable, of separate and/or consolidated balance sheets or income accounts of any person directly or indirectly controlling or controlled by the issuer, or any person under direct or indirect common control with the issuer; but in the case of the reports of any person whose methods of accounting are prescribed under the provisions of any law of the United States, or any rule or regulation thereunder, the rules and regulations of the Commission with respect to reports shall not be inconsistent with the requirements imposed by such law or rule or regulation in respect of the same subject matter (except that such rules and regulations of the Commission may be inconsistent with such requirements to the extent that the Commission determines that the public interest or the protection of investors so requires).

(2) Every issuer which has a class of securities registered pursuant to section 78*l* of this title and every issuer which is required to file reports pursuant to section 78*o*(d) of this title shall--

(A) 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;

(B) devise and maintain a system of internal accounting controls sufficient to provide reasonable assurances that--

(i) transactions are executed in accordance with management's general or specific authorization;

(ii) transactions are recorded as necessary (I) to permit preparation of financial statements in conformity with generally accepted accounting principles or any other criteria applicable to such statements, and (II) to maintain accountability for assets;

(iii) access to assets is permitted only in accordance with management's general or specific authorization; and

(iv) the recorded accountability for assets is compared with the existing assets at reasonable intervals and appropriate action is taken with respect to any differences; and

(C) notwithstanding any other provision of law, pay the allocable share of such issuer of a reasonable annual accounting support fee or fees, determined in accordance with section 7219 of this title.

(3)(A) With respect to matters concerning the national security of the United States, no duty or liability under paragraph (2) of this subsection shall be imposed upon any person acting in cooperation with the head of any Federal department or agency responsible for such matters if such act in cooperation with such head of a department or agency was done upon the specific, written directive of the head of such department or agency pursuant to Presidential authority to issue such directives. Each directive issued under this paragraph shall set forth the specific facts and circumstances with respect to which the provisions of this paragraph are to be invoked. Each such directive shall, unless renewed in writing, expire one year after the date of issuance.

(B) Each head of a Federal department or agency of the United States who issues a directive pursuant to this paragraph shall maintain a complete file of all such directives and shall, on October 1 of each year, transmit a summary of matters covered by such directives in force at any time during the previous year to the Permanent Select Committee on Intelligence of the House of Representatives and the Select Committee on Intelligence of the Senate.

(4) No criminal liability shall be imposed for failing to comply with the requirements of paragraph (2) of this subsection except as provided in paragraph (5) of this subsection.

(5) No person shall knowingly circumvent or knowingly fail to implement a system of internal accounting controls or knowingly falsify any book, record, or account described in paragraph (2).

(6) Where an issuer which has a class of securities registered pursuant to section 78*l* of this title or an issuer which is required to file reports pursuant to section 78*o*(d) of this title holds 50 per centum or less of the voting power with respect to a domestic or foreign firm, the provisions of paragraph (2) require only that the issuer proceed in good faith to use its influence, to the extent reasonable under the issuer's circumstances, to cause such domestic or foreign firm to devise and maintain a system of internal accounting controls consistent with paragraph (2). Such circumstances include the relative degree of the issuer's ownership of the domestic or foreign firm and the laws and practices governing the business operations of the country in which such firm is located. An issuer which demonstrates good faith efforts to use such influence shall be conclusively presumed to have complied with the requirements of paragraph (2).

(7) For the purpose of paragraph (2) of this subsection, the terms “reasonable assurances” and “reasonable detail” mean such level of detail and degree of assurance as would satisfy prudent officials in the conduct of their own affairs.

(c) Alternative reports

If in the judgment of the Commission any report required under subsection (a) of this section is inapplicable to any specified class or classes of issuers, the Commission shall require in lieu thereof the submission of such reports of comparable character as it may deem applicable to such class or classes of issuers.

(d) Reports by persons acquiring more than five per centum of certain classes of securities

(1) Any person who, after acquiring directly or indirectly the beneficial ownership of any equity security of a class which is registered pursuant to section 78*l* of this title, or any equity security of an insurance company which would have been required to be so registered except for the exemption contained in section 78*l*(g)(2)(G) of this title, or any equity security issued by a closed-end investment company registered under the Investment Company Act of 1940 [15 U.S.C.A. § 80a-1 et seq.] or any equity security issued by a Native Corporation pursuant to section 1629c(d)(6) of Title 43, or otherwise becomes or is deemed to become a beneficial owner of any of the foregoing upon the purchase or sale of a security-based swap that the Commission may define by rule, and is directly or indirectly the beneficial owner of more than 5 per centum of such class shall, within ten days after such acquisition or within such shorter time as the Commission may establish by rule, file with the Commission, a statement containing such of the following

APPENDIX 4

United States Code Annotated
Title 18. Crimes and Criminal Procedure (Refs & Annos)
Part I. Crimes (Refs & Annos)
Chapter 73. Obstruction of Justice (Refs & Annos)

18 U.S.C.A. § 1514A

§ 1514A. Civil action to protect against retaliation in fraud cases

Effective: July 22, 2010
Currentness

(a) Whistleblower Protection for Employees of Publicly Traded Companies.--No company with a class of securities registered under section 12 of the Securities Exchange Act of 1934 (15 U.S.C. 78*l*), or that is required to file reports under section 15(d) of the Securities Exchange Act of 1934 (15 U.S.C. 78*o*(d)) including any subsidiary or affiliate whose financial information is included in the consolidated financial statements of such company, or nationally recognized statistical rating organization (as defined in section 3(a) of the Securities Exchange Act of 1934 (15 U.S.C. 78c), [1] or any officer, employee, contractor, subcontractor, or agent of such company or nationally recognized statistical rating organization, may discharge, demote, suspend, threaten, harass, or in any other manner discriminate against an employee in the terms and conditions of employment because of any lawful act done by the employee--

(1) to provide information, cause information to be provided, or otherwise assist in an investigation regarding any conduct which the employee reasonably believes constitutes a violation of section 1341, 1343, 1344, or 1348, any rule or regulation of the Securities and Exchange Commission, or any provision of Federal law relating to fraud against shareholders, when the information or assistance is provided to or the investigation is conducted by--

(A) a Federal regulatory or law enforcement agency;

(B) any Member of Congress or any committee of Congress; or

(C) a person with supervisory authority over the employee (or such other person working for the employer who has the authority to investigate, discover, or terminate misconduct); or

(2) to file, cause to be filed, testify, participate in, or otherwise assist in a proceeding filed or about to be filed (with any knowledge of the employer) relating to an alleged violation of section 1341, 1343, 1344, or 1348, any rule or regulation of the Securities and Exchange Commission, or any provision of Federal law relating to fraud against shareholders.

(b) Enforcement Action.--

(1) In general.--A person who alleges discharge or other discrimination by any person in violation of subsection (a) may seek relief under subsection (c), by--

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(A) filing a complaint with the Secretary of Labor; or

(B) if the Secretary has not issued a final decision within 180 days of the filing of the complaint and there is no showing that such delay is due to the bad faith of the claimant, bringing an action at law or equity for de novo review in the appropriate district court of the United States, which shall have jurisdiction over such an action without regard to the amount in controversy.

(2) Procedure.--

(A) In general.--An action under paragraph (1)(A) shall be governed under the rules and procedures set forth in section 42121(b) of title 49, United States Code.

(B) Exception.--Notification made under section 42121(b)(1) of title 49, United States Code, shall be made to the person named in the complaint and to the employer.

(C) Burdens of proof.--An action brought under paragraph (1)(B) shall be governed by the legal burdens of proof set forth in section 42121(b) of title 49, United States Code.

(D) Statute of limitations.--An action under paragraph (1) shall be commenced not later than 180 days after the date on which the violation occurs, or after the date on which the employee became aware of the violation.

(E) Jury trial.--A party to an action brought under paragraph (1)(B) shall be entitled to trial by jury.

(c) Remedies.--

(1) In general.--An employee prevailing in any action under subsection (b)(1) shall be entitled to all relief necessary to make the employee whole.

(2) Compensatory damages.--Relief for any action under paragraph (1) shall include--

(A) reinstatement with the same seniority status that the employee would have had, but for the discrimination;

(B) the amount of back pay, with interest; and

(C) compensation for any special damages sustained as a result of the discrimination, including litigation costs, expert witness fees, and reasonable attorney fees.

(d) Rights Retained by Employee.--Nothing in this section shall be deemed to diminish the rights, privileges, or remedies of any employee under any Federal or State law, or under any collective bargaining agreement.

(e) Nonenforceability of Certain Provisions Waiving Rights and Remedies or Requiring Arbitration of Disputes.--

(1) Waiver of rights and remedies.--The rights and remedies provided for in this section may not be waived by any agreement, policy form, or condition of employment, including by a predispute arbitration agreement.

(2) Predispute arbitration agreements.--No predispute arbitration agreement shall be valid or enforceable, if the agreement requires arbitration of a dispute arising under this section.

CREDIT(S)

(Added Pub.L. 107-204, Title VIII, § 806(a), July 30, 2002, 116 Stat. 802; amended Pub.L. 111-203, Title IX, §§ 922(b), (c), 929A, July 21, 2010, 124 Stat. 1848, 1852.)

Notes of Decisions (154)

Footnotes

1 So in original. Another closing parenthesis probably should precede the comma.

18 U.S.C.A. § 1514A, 18 USCA § 1514A

Current through P.L. 116-29.

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APPENDIX 5

Code of Federal Regulations
Title 17. Commodity and Securities Exchanges
Chapter II. Securities and Exchange Commission
Part 240. General Rules and Regulations, Securities Exchange Act of 1934 (Refs & Annos)
Subpart A. Rules and Regulations Under the Securities Exchange Act of 1934
Regulation 13b–2: Maintenance of Records and Preparation of Required Reports

17 C.F.R. § 240.13b2–1

§ 240.13b2–1 Falsification of accounting records.

Currentness

No person shall directly or indirectly, falsify or cause to be falsified, any book, record or account subject to section 13(b)(2)(A) of the Securities Exchange Act.

(Authority: 15 U.S.C. 78m(b)(2); 15 U.S.C. 78m(a), 78m(b)(1), 78*o*(d), 78j(b), 78n(a), 78t(b), 78t(c))

Credits
[44 FR 10970, Feb. 23, 1979]

AUTHORITY: 15 U.S.C. 77c, 77d, 77g, 77j, 77s, 77z–2, 77z–3, 77eee, 77ggg, 77nnn, 77sss, 77ttt, 78c, 78c–3, 78c–5, 78d, 78e, 78f, 78g, 78i, 78j, 78j–1, 78k, 78k–1, 78***l***, 78m, 78n, 78n–1, 78***o***, 78***o***–4, 78***o***–10, 78p, 78q, 78q–1, 78s, 78u–5, 78w, 78x, 78***ll***, 78mm, 80a–20, 80a–23, 80a–29, 80a–37, 80b–3, 80b–4, 80b–11, 7201 et seq.; and 8302; 7 U.S.C. 2(c)(2)(E); 12 U.S.C. 5221(e)(3); 18 U.S.C. 1350; and Pub.L. 111–203, 939A, 124 Stat. 1887 (2010); and secs. 503 and 602, Pub.L. 112–106, 126 Stat. 326 (2012), unless otherwise noted.; Section 240.3a4–1 also issued under secs. 3 and 15, 89 Stat. 97, as amended, 89 Stat. 121 as amended;; Section 240.3a12–8 also issued under 15 U.S.C. 78a et seq., particularly secs. 3(a)(12), 15 U.S.C. 78c(a)(12), and 23(a), 15 U.S.C. 78w(a);; Section 240.3a12–10 also issued under 15 U.S.C. 78b and c;; Section 240.3a12–9 also issued under secs. 3(a)(12), 7(c), 11(d)(1), 15 U.S.C. 78c(a)(12), 78g(c), 78k(d)(1);; Sections 240.3a43–1 and 240.3a44–1 also issued under sec. 3; 15 U.S.C. 78c;; Sections 3a67–1 through 3a67–9 and 3a71–1 and 3a71–2 are also issued under Pub.L. 111–203, §§ 712, 761(b), 124 Stat. 1841 (2010).; Section 240.3a67–10, 240.3a71–3, 240.3a71–4, 240.3a71–5, and 240.3a71–6 are also issued under Pub.L. 111–203, secs. 712, 761(b), 124 Stat. 1754 (2010), and 15 U.S.C. 78dd(c).; Sections 240.3a71–3 and 240.3a71–5 are also issued under Pub.L. 111–203, sec. 761(b), 124 Stat. 1754 (2010), and 15 U.S.C. 78dd(c).; Section 240.3b–6 is also issued under 15 U.S.C. 77f, 77g, 77h, 77j, 77s(a).; Section 240.3b–9 also issued under secs. 2, 3 and 15, 89 Stat. 97, as amended, 89 Stat. 121, as amended (15 U.S.C. 78b, 78c, 78***o***);; Section 240.9b–1 is also issued under sec. 2, 7, 10, 19(a), 48 Stat. 74, 78, 81, 85; secs. 201, 205, 209, 120, 48 Stat. 905, 906, 908; secs. 1–4, 8, 68 Stat. 683, 685; sec. 12(a), 73 Stat. 143; sec. 7(a), 74 Stat. 412; sec. 27(a), 84 Stat. 1433; sec. 308(a)(2), 90 Stat. 57; sec. 505, 94 Stat. 2292; secs. 9, 15, 23(a), 48 Stat. 889, 895, 901; sec. 230(a), 49 Stat. 704; secs. 3, 8, 49 Stat. 1377, 1379; sec. 2, 52 Stat. 1075; secs. 6, 10, 78 Stat. 570–574, 580; sec. 11(d), 84 Stat. 121; sec. 18, 89 Stat. 155; sec. 204, 91 Stat. 1500; 15 U.S.C. 77b, 77g, 77j, 77s(a), 78i, 78***o***, 78w(a);; Section 240.10b–10 is also issued under secs. 2, 3, 9, 10, 11, 11A, 15, 17, 23, 48 Stat. 891, 89 Stat. 97, 121, 137, 156, (15 U.S.C. 78b, 78c, 78i, 78j, 78k, 78k–1, 78***o***, 78q);; Section 240.12a–7 also issued under 15 U.S.C. 78a et seq., particularly secs. 3(a)(12), 15 U.S.C. 78c(a)(12), 6, 15 U.S.C. 78(f), 11A, 15 U.S.C. 78k, 12, 15 U.S.C. 78(l), and 23(a)(1), 15 U.S.C. 78(w)(a)(1).; Sections 240.12b–1 to 240.12b–36 also issued under secs. 3, 12, 13, 15, 48 Stat. 892, as amended 894, 895, as amended; 15 U.S.C. 78c, 78***l***, 78m, 78***o***;; Section 240.12b–15 is also issued under secs. 3(a) and 302, Pub.L. No. 107–204, 116 Stat. 745.; Section 240.12b–25 is also issued

APPENDIX 6

U.S. Securities and Exchange Commission

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 46017 / June 3, 2002

ACCOUNTING AND AUDITING ENFORCEMENT
Release No. 1563 / June 3, 2002

ADMINISTRATIVE PROCEEDING
File No. 3-10789

In the Matter of MICROSOFT CORPORATION, Respondent.	: : : : :	ORDER INSTITUTING PUBLIC ADMINISTRATIVE PROCEEDINGS PURSUANT TO SECTION 21C OF THE SECURITIES EXCHANGE ACT OF 1934, MAKING FINDINGS AND IMPOSING CEASE-AND-DESIST ORDER

I.

The Securities and Exchange Commission ("Commission") deems it appropriate that public administrative proceedings be, and hereby are, instituted pursuant to Section 21C of the Securities Exchange Act of 1934 (the "Exchange Act") to determine whether Microsoft Corporation ("Respondent") violated Sections 13(a), 13(b)(2)(A), and 13(b)(2)(B) of the Exchange Act and Rules 12b-20, 13a-1 and 13a-13 thereunder.

II.

In anticipation of the institution of these administrative proceedings, Microsoft has submitted an Offer of Settlement ("Offer") that the Commission has determined to accept. Solely for the purposes of these proceedings, and for any other proceeding brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the findings set forth below, except as to jurisdiction of the Commission over it and over the subject matter of these proceedings, which Respondent admits, Respondent consents to the entry of this Order Instituting Public Administrative Proceedings Pursuant to Section 21C of the Securities Exchange Act of 1934, Making Findings and Imposing Cease-and-Desist Order (the "Order"). The Commission has determined that it is appropriate to accept the Offer and accordingly is issuing this Order.

III.

Accordingly, IT IS HEREBY ORDERED, that administrative proceedings pursuant to Section 21C of the Exchange Act be, and they hereby are, instituted.

IV.

FINDINGS

On the basis of this Order and the Offer of Settlement submitted by Respondent, the Commission finds that:

A. Respondent

Microsoft Corporation is a Washington corporation with its principal place of business in Redmond, Washington. Since its initial public offering in 1986, Microsoft's common stock has been registered with the Commission pursuant to Section 12(g) of the Exchange Act [15 U.S.C. § 78l(g)] and is listed on the NASDAQ Stock Market, Inc. At all times relevant herein, Microsoft was required to make and file certain periodic reports with the Commission. Microsoft's principal lines of business consist of providing software for personal computers, office systems and the Internet.

1 Facts

1. Summary

During Microsoft's fiscal years[1] ended June 30, 1995, June 30, 1996, June 30, 1997 and June 30, 1998 (the "relevant period"), Microsoft maintained undisclosed reserves, accruals, allowances and liability accounts (collectively "reserves" or "reserve accounts") that (a) were not in conformity with generally accepted accounting principles ("GAAP") to a material extent, and/or (b) lacked properly documented support and substantiation, as required by the federal securities laws. Moreover, Microsoft failed to maintain internal controls that were adequate under the federal securities laws. Specifically, during the relevant period, Microsoft maintained between approximately $200 million and $900 million in unsupported and undisclosed reserves, a significant portion of which did not comply with GAAP, which resulted in material inaccuracies in filings made by Microsoft with the Commission.

2. Microsoft Recorded Reserves Without a Properly Documented or Substantiated Basis

At the end of each fiscal quarter, certain of Microsoft's senior financial personnel, reviewed its reserves. The controllers of the operating units of Microsoft would provide these senior financial personnel with estimates for reserves for their units. These operational reserves represented contingencies faced by each individual operating unit and were described in Microsoft's internal documents as "hard contingencies supported by analysis," "transaction-based," and "systematic." Microsoft's internal accounting policies dictated that operating-level controllers use formulas and documented analyses to estimate and calculate operating reserves each quarter. Additionally, Microsoft's stated policy was to periodically reconcile the operational reserves to the general ledger to ensure that a documented basis existed for the journal entries underlying the operational reserve balances.

By contrast, Microsoft created and maintained certain other reserves that existed only at the corporate level. These corporate reserves were not determined from factually based formulas, analysis or statistics. They were described in Microsoft's records as "based, in part, on judgment regarding the likelihood of future business events." They were also exempted from

Microsoft's account reconciliation process for operational reserves described above, which was part of Microsoft's ordinary accounting procedures and was designed to ensure that there was a substantiated basis for the company's financial statements.

In addition, senior Microsoft financial personnel who reviewed reserve estimates from operating units frequently added additional amounts to the reserve estimates of the operating units, without the analysis or support that Microsoft required of its operating units. These corporate level additions were not determined from factually based formulas, analysis or statistics. Microsoft's records also described them as "based, in part, on judgment regarding the likelihood of future business events." These corporate level additions were also exempted from the company's account reconciliation process.

These senior Microsoft financial personnel did not obtain sufficient information concerning Microsoft's historical or actual experience with respect to the reserves being accrued for at the corporate level, nor did they rely on the documentation that was prepared by Microsoft's operating subsidiaries or units. Instead, they relied on their subjective judgments in making adjustments to those reserves that existed at the corporate level, without any significant factual support or analysis, and similarly made additions to the operating level reserves, without any significant factual support or analysis, such that these reserves significantly exceeded the amounts that would have been supported by the information from the operational level. As a result, these reserves did not have the documented support as required by the federal securities laws and lacked sufficient substantiation under GAAP.

Following the above-described quarterly financial review, senior financial personnel used the results of the review to prepare Microsoft's publicly filed financial statements and to cause journal entries to be made to Microsoft's general ledger reflecting the corporate level adjustments to the above-described reserves.

4. **Reserves Maintained or Used Without Proper Support or Basis**

a. **Cyclical Accrual For Marketing Expenses**

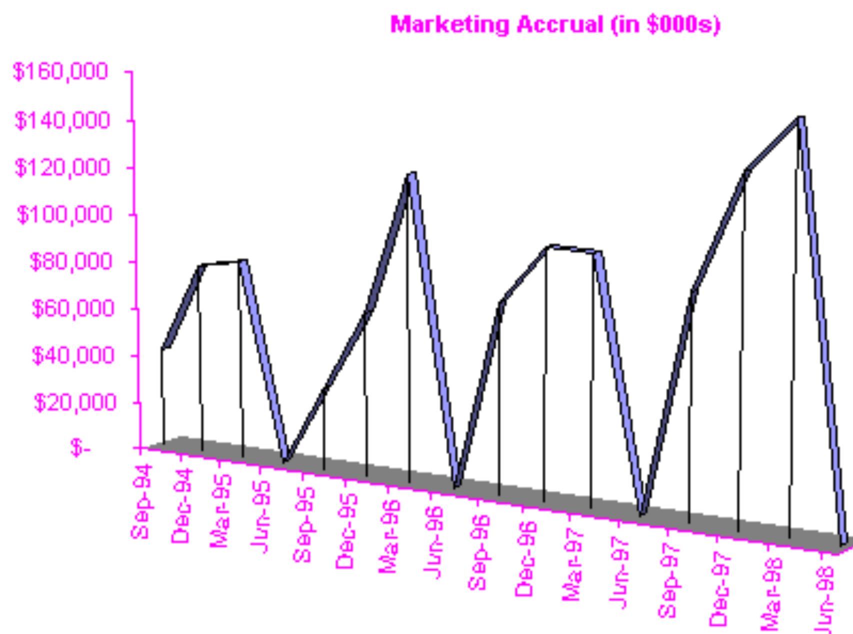
Marketing expenses represented the largest expense item on Microsoft's statement of operations. For management purposes, Microsoft established budgets for marketing expenses for each fiscal quarter and fiscal year. Management generally determined these budgets as a percentage of forecasted revenue.

Microsoft typically recorded budgeted marketing expenses as its reported marketing expenses when preparing its quarterly reports filed with the Commission, even though it did not have a documented factual basis for believing that its marketing budget was a reasonable estimation of its marketing expenses. In order to account for the difference between the marketing expenses recorded in its books and records, and its budgeted marketing expenses, Microsoft maintained a "marketing accrual," to which these differences were recorded. Microsoft generally budgeted quarterly marketing expenses as a substantially constant percentage of revenue and the effect of this practice was to depict marketing expense as a substantially constant percentage of revenue on a quarterly basis throughout the year. During the first three quarters of a fiscal year, recorded expenses typically were less than budgeted expenses. Microsoft

treated the difference between recorded expenses and budgeted expense as incurred but unbilled expenses. At the end of each of the first three fiscal quarters, Microsoft adjusted recorded marketing expense by increasing recorded expenses to the budgeted amount. The difference between recorded expenses and budget were credited to the marketing accrual. Because Microsoft had insufficient support for recording its marketing expenses as the budgeted amount, this practice did not satisfy the requirement of GAAP that marketing expenses be recorded as and when they are actually incurred.

Microsoft's marketing accrual (*i.e.,* the account containing the difference between recorded expenses and its budgeted marketing expenses) tended to increase during the first three fiscal quarters because, during each of these quarters, the difference between recorded and budgeted marketing expenses would be added into reported expenses. At the end of each fiscal year, Microsoft reversed the marketing accrual and released it into income.[2] The following chart shows the quarterly balances of the marketing accrual.

Chart One



The marketing accrual was not documented as required by the federal securities laws and, to a significant extent, was not in conformity with GAAP. Because Microsoft did not analyze and document the use of budgeted amounts as a proxy for actual marketing expenditures, its quarterly financial statements filed with the Commission during the first three quarters of its fiscal years 1995, 1996, 1997 and 1998 did not comply with the requirements of the federal securities laws.

a. **Non-Cyclical Reserves**

In addition to the annual cyclical accrual for marketing expenses, Microsoft maintained six other reserve accounts that failed to comply with the federal securities laws. These reserve accounts, along with the marketing accrual discussed above, were not in conformity with GAAP to a material extent and/or lacked properly documented support and substantiation as required by the federal securities laws.

i. **OEM Sales Reserve**

Microsoft derives a significant amount of revenues from licensing agreements with manufacturers of personal computers. These manufacturers were referred to as original equipment manufacturers ("OEMs"). The OEMs installed Microsoft software on

new computers that they sold. Under the licensing agreements, the OEMs were required to report in arrears on a periodic basis the number of computers shipped with pre-installed software and the amount of net royalties due to Microsoft from the sales. In accounting for OEM revenue, Microsoft maintained certain accounts, including a so-called OEM GAAP accrual, which was accrued for earned but unbilled revenue, and a so-called OEM sales reserve.

The OEM GAAP accrual was estimated by OEM accounting specialists at the staff-level of Microsoft and was based upon forecasts having a substantial factual and analytical basis. By contrast, however, the OEM sales reserve was determined by the senior Microsoft financial personnel responsible for the corporate level reserve accounts. However, Microsoft had no substantiated basis for the corporate level OEM sales reserve or any methodology by which the balance in the OEM sales reserve was calculated. Accordingly, the OEM sales reserve was not documented as required by the federal securities laws and, to a significant extent, was not in conformity with GAAP. From time to time, as shown in Table 1, Microsoft released portions of the OEM sales reserve into income.

ii. **Accelerated Depreciation**

Microsoft maintained a corporate reserve for accelerated depreciation. In fiscal years 1996 and 1997, Microsoft, for external reporting purposes, reduced the useful lives of its personal computers from three years to one year and the useful lives of its buildings from thirty years to fifteen years. These changes in depreciable lives were made because: (a) in the day-to-day management of the company, Microsoft treated personal computers as consumable supplies, and (b) buildings and related improvements were routinely gutted and refitted as groups moved freely about the Microsoft campus.

Without regard to the GAAP requirement that changes in depreciable lives of assets be accounted for *prospectively* rather than retrospectively,[3] Microsoft accounted for the impact of the new asset lives cumulatively. In other words, Microsoft accounted for its personal computers and buildings in fiscal years 1996 and 1997 as if they had always had useful lives of one and fifteen years respectively. This resulted in these assets having net book values that were less than they would have been in the absence of the changes in useful lives. The difference in value generated by the old and new useful lives was charged to depreciation expense and credited to an account that Microsoft called "accelerated depreciation."

Microsoft failed to disclose (a) the changes in asset lives and their effect, and (b) the use of the improper method of accounting for the accelerated depreciation reserve. The accelerated depreciation account was not in compliance with GAAP.

iii. **Inventory Obsolescence**

Statement of Financial Accounting Standards No. 5 ("SFAS 5") requires that

certain conditions exist before loss contingencies representing liabilities or asset impairments may be determined and the amount of a reserve accrued. The loss must be probable as of the balance sheet date and reasonably estimable; significantly, the loss must have occurred prior to the creation of the loss contingency and must not be in the future.[4] Furthermore, SFAS 5 prohibits the accrual of reserves for general or unspecified risks.[5] As discussed below, Microsoft did not comply with SFAS 5 because the company's senior financial personnel did not properly assess whether inventory losses had occurred, and made no effort to reasonably estimate the losses.

Microsoft maintained a corporate level reserve account for inventory obsolescence that supplemented the inventory obsolescence reserve accounts determined at the operating level. Microsoft maintained factually supported inventory reserve accounts at the operating level, where operations personnel evaluated and documented the need for such accounts. The corporate level inventory obsolescence reserve had no substantiated basis, as required by SFAS 5. This corporate reserve was not associated with any specific inventory nor was it supported by any statistical or documented analysis during the fiscal years ended June 30, 1995 through June 30, 1998. The corporate reserves, when combined with operating level reserves, caused the net book value of Microsoft's consolidated inventory to be *negative* at the end of the fiscal year ended June 30, 1997. This reserve was, to a significant extent, not in compliance with GAAP, and was not documented as required by the federal securities laws.

iv. **Impaired Long Term Assets**

Microsoft maintained a corporate reserve account for the valuation of financial assets. According to internal documents, the reserve's purpose was to "allow for potential losses, upon disposition, of Microsoft's financial assets." These financial assets consisted of equity investments made in various technology companies. Microsoft amortized the cost of these financial assets with monthly charges to income without any basis for the charges. The appropriate treatment under GAAP would have been to carry the assets at cost or write down the assets to their fair value in the event that the assets had suffered other than temporary declines in fair value.[6] Microsoft did not have a proper basis under GAAP for the amounts of the monthly charges in the account during its fiscal years 1995 through 1998.

4. **Interest Rate Fluctuations**

According to internal documents, the reserve account for interest income was designed to "provide for shifts in interest rates or other economic events which may adversely impact Microsoft's return on its portfolio." Adjustments to the interest income reserve were made at the "discretion" of senior financial personnel, and Microsoft did not have any factual analysis or statistical support for the balance in this account. This reserve was determined in a manner that did not comply with GAAP, and its balance and the adjustments thereto lacked a proper basis under GAAP.[7]

vi. **Manufacturing Facilities**

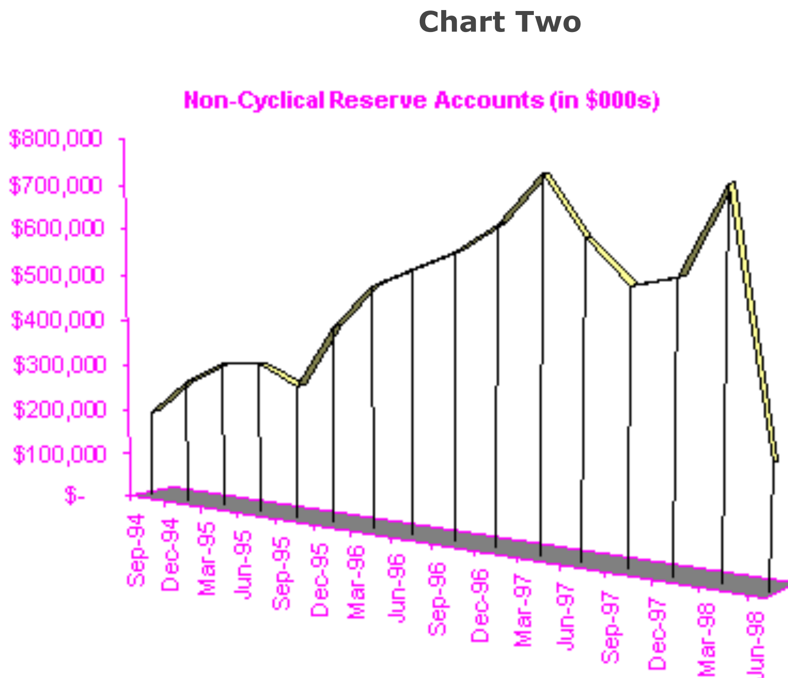
Microsoft created a reserve in 1996 because it believed that the value of certain of its manufacturing facilities would be impaired because it was taking steps to outsource certain of its manufacturing activities and dispose

of its own facilities that had been engaged in this manufacturing. Microsoft established a reserve account to provide for expenses associated with the disposition of its own plant and equipment, and associated employee-related expenses. Microsoft had no analysis or other factual basis supporting the balance in this account and, consequently, could not establish whether this account pertained to probable losses arising from an event or circumstance that had already occurred or whether it pertained to losses arising from future contingencies. This account therefore was not documented as required by the federal securities laws, and the balances in the account were not determined in a manner that was in conformity with GAAP.

c. **Cumulative Balances of Non-Cyclical Reserves**

The cumulative balance of the six non-cyclical reserve accounts discussed above is depicted in the chart below:

Chart Two



Moreover, the amounts of quarterly adjustments to the above described six accounts, together with the amounts of the marketing expenses accrual, are depicted below:

Table 1 is attached.

The balances and adjustments displayed in Chart Two and Table 1 above did not have the documentary support required by the federal securities laws, and a material portion thereof lacked a proper basis under GAAP.

4. **Microsoft's Filings With the Commission**

As a result of the foregoing, Microsoft filed with the Commission periodic reports and other filings during fiscal years 1995, 1996, 1997, and 1998 that included, directly or by incorporation, financial statements that misrepresented Microsoft's financial results by sometimes overstating income and on other occasions understating income.

5. **Microsoft's Failure to Maintain Accurate and Complete Books and Records**

In connection with its corporate reserve accounts, Microsoft failed to apply its own internal controls requiring a reconciliation of accounts to the general ledger. As noted above, the corporate reserve accounts were excepted from the company-wide policy that required all accounts be reconciled to the general ledger at least once per quarter.

Microsoft's accounting policies required the reconciliation of accounts as part of an extensive process to close the company's books each quarter. Among other things, the controllers and members of the corporate controllers' group reviewed activity in each general ledger account and reconciled the account balances to the general ledger, attaching supporting documentation for all activity and account balances. The reconciliation policy and process were part of a process designed to help ensure the accuracy and integrity of Microsoft's internally and externally reported financial information. However, Microsoft failed to include the corporate reserve accounts in this reconciliation process. As a result, Microsoft lacked an important safeguard for helping ensure that the adjustments to the corporate reserve accounts and the account balances themselves were appropriate or accurately reported in conformity with GAAP.

V.

LEGAL ANALYSIS OF VIOLATIONS OF THE EXCHANGE ACT REPORTING, RECORD KEEPING, AND INTERNAL CONTROLS PROVISIONS

Section 13(a) of the Exchange Act requires issuers of registered securities to file periodic reports with the Commission containing information prescribed by specific Commission rules. Rules 13a-1 and 13a-13 require, respectively, the filing of Forms 10-K and 10-Q. Rule 12b-20 requires, in addition to information required in periodic reports by Commission rules, such further material information as may be necessary to make the required statements not misleading. Among other things, Microsoft was required to comply with GAAP.[8]

Microsoft was required to file periodic reports with the Commission during its fiscal years 1995 through 1998. These reports were required to be complete and accurate. See SEC v. Savoy Industries, 587 F.2d 1149, 1165 (D.C. Cir. 1978). As previously discussed, Microsoft recorded and adjusted its reserve accounts in ways not permitted under GAAP in its quarterly and annual filings. To a material extent, these reserve accounts lacked factually substantiated bases, and were therefore improper. The limited and inadequate documentation that Microsoft created with respect to these reserve accounts either did not substantiate any permitted basis for the accounts or indicated that the accounts were otherwise impermissible under GAAP. The inclusion of these reserves in Microsoft's financial statements and of the adjustments thereto in its income statements resulted in misstatements of income in certain periodic reports filed with the Commission during the relevant period, which were material. Consequently, Microsoft violated Section 13(a) and Rules 13a-1, 13a-13 and 12b-20 promulgated thereunder.

Section 13(b)(2)(A) of the Exchange Act 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." "A company's `books and records' include not only general ledgers and accounting entries, but also memoranda and internal corporate reports." In the Matter of Gibson Greetings, Inc., Ward A. Cavanaugh, and James H. Johnsen, Admin. Proc. File No. 3-8866, Release No. 34-36357, 60 SEC Docket 1401 (Oct. 11, 1995). Further, Section 13(b)(2)(B) of the Exchange Act requires issuers to devise and maintain a system of internal accounting controls sufficient to provide reasonable assurances that transactions are recorded as necessary to permit preparation of financial statements in conformity with generally accepted accounting principles. As described above, Microsoft failed to keep books and records that were in conformity with Section 13(b)(2)(A).

Microsoft also had deficient internal controls relating to the corporate reserve accounts. The documentation created by Microsoft either did not adequately explain the basis for any of the corporate reserves or adjustments made to those accounts, or indicated that they were impermissible. In fact, senior Microsoft financial personnel relied upon their undocumented, subjective judgment rather than factual analysis or statistics in establishing and adjusting the corporate reserve accounts. In addition, the corporate reserve accounts were excluded from the company-wide reconciliation process, which required that all balance sheet accounts be reconciled to the general ledger with appropriate documentation of activity.

Consequently, Microsoft violated Sections 13(b)(2)(A) and 13(b)(2)(B) of the Exchange Act.

VI.

Based on the foregoing, the Securities and Exchange Commission finds that Microsoft violated Sections 13(a), 13(b)(2)(A) and 13(b)(2)(B) of the Exchange Act, and Rules 12b-20, 13a-1 and 13a-13 promulgated thereunder.

VII.

In view of the foregoing, it is appropriate to impose the sanction specified in Respondent's Offer of Settlement.

VIII.

ORDER

ACCORDINGLY, IT IS HEREBY ORDERED THAT, pursuant to Section 21C of the Exchange Act, Microsoft cease-and-desist from committing or causing any violations of, and committing or causing any future violations of, Sections 13(a), 13(b)(2)(A), and 13(b)(2)(B) of the Exchange Act, and Rules 12b-20, 13a-1, and 13a-13 promulgated thereunder.

By the Commission.

Jonathan G. Katz
Secretary

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1 Microsoft's fiscal year begins on July 1 and ends on June 30.

2 As a consequence of this reversal, the marketing accrual did not affect fiscal year-end results.

3 See, APB Opinion No. 20; Accounting Changes, which requires changes in estimates (such as depreciable lives of fixed assets) to be accounted for prospectively.

4 Statement of Financial Accounting Standards No. 5, Paragraph 8.

5 *Id.* at Paragraph 14.

6 Accounting Principles Board Opinion No. 18, ¶ 6a.

7 Statement of Financial Accounting Standards No. 115, ¶2; 16, provides that individual securities classified as either available-for-sale or held-to-maturity shall be written down to fair value if the enterprise determines that declines in fair value are other than temporary.

8 17 C.F.R. § 210.4-01(a)(1).

http://www.sec.gov/litigation/admin/34-46017.htm

APPENDIX 7

Public Law 95-213
95th Congress

An Act

Dec. 19, 1977
[S. 305]

To amend the Securities Exchange Act of 1934 to make it unlawful for an issuer of securities registered pursuant to section 12 of such Act or an issuer required to file reports pursuant to section 15(d) of such Act to make certain payments to foreign officials and other foreign persons, to require such issuers to maintain accurate records, and for other purposes.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

Securities Exchange Act of 1934, amendment.
Foreign Corrupt Practices Act of 1977.
15 USC 78a note.

TITLE I—FOREIGN CORRUPT PRACTICES

SHORT TITLE

Sec. 101. This title may be cited as the "Foreign Corrupt Practices Act of 1977".

ACCOUNTING STANDARDS

Assets, transactions and dispositions.
15 USC 78m.

Sec. 102. Section 13(b) of the Securities Exchange Act of 1934 (15 U.S.C. 78q(b)) is amended by inserting "(1)" after "(b)" and by adding at the end thereof the following:

15 USC 78*l*.
Post, p. 1500.
Records, maintenance.

"(2) Every issuer which has a class of securities registered pursuant to section 12 of this title and every issuer which is required to file reports pursuant to section 15(d) of this title shall—

"(A) make and keep books, records, and accounts, which, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the issuer; and

Internal accounting controls, establishment.

"(B) devise and maintain a system of internal accounting controls sufficient to provide reasonable assurances that—

"(i) transactions are executed in accordance with management's general or specific authorization;

"(ii) transactions are recorded as necessary (I) to permit preparation of financial statements in conformity with generally accepted accounting principles or any other criteria applicable to such statements, and (II) to maintain accountability for assets;

"(iii) access to assets is permitted only in accordance with management's general or specific authorization; and

"(iv) the recorded accountability for assets is compared with the existing assets at reasonable intervals and appropriate action is taken with respect to any differences.

Exemption directive, issuance and expiration.

"(3)(A) With respect to matters concerning the national security of the United States, no duty or liability under paragraph (2) of this subsection shall be imposed upon any person acting in cooperation with the head of any Federal department or agency responsible for such matters if such act in cooperation with such head of a department or agency was done upon the specific, written directive of the head of such department or agency pursuant to Presidential authority to issue such directives. Each directive issued under this paragraph shall set forth the specific facts and circumstances with respect to which the provisions of this paragraph are to be invoked. Each such directive shall, unless renewed in writing, expire one year after the date of issuance.

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"(B) Each head of a Federal department or agency of the United States who issues a directive pursuant to this paragraph shall maintain a complete file of all such directives and shall, on October 1 of each year, transmit a summary of matters covered by such directives in force at any time during the previous year to the Permanent Select Committee on Intelligence of the House of Representatives and the Select Committee on Intelligence of the Senate.".

File maintenance. Annual summary, transmittal to congressional committees.

FOREIGN CORRUPT PRACTICES BY ISSUERS

SEC. 103. (a) The Securities Exchange Act of 1934 is amended by inserting after section 30 the following new section:

"FOREIGN CORRUPT PRACTICES BY ISSUERS

"SEC. 30A. (a) It shall be unlawful for any issuer which has a class of securities registered pursuant to section 12 of this title or which is required to file reports under section 15(d) of this title, or for any officer, director, employee, or agent of such issuer or any stockholder thereof acting on behalf of such issuer, to make use of the mails or any means or instrumentality of interstate commerce corruptly in furtherance of an offer, payment, promise to pay, or authorization of the payment of any money, or offer, gift, promise to give, or authorization of the giving of anything of value to—

15 USC 78dd-1. 15 USC 78*l*. *Post*, p. 1500.

"(1) any foreign official for purposes of—

"(A) influencing any act or decision of such foreign official in his official capacity, including a decision to fail to perform his official functions; or

"(B) inducing such foreign official to use his influence with a foreign government or instrumentality thereof to affect or influence any act or decision of such government or instrumentality,

in order to assist such issuer in obtaining or retaining business for or with, or directing business to, any person;

"(2) any foreign political party or official thereof or any candidate for foreign political office for purposes of—

"(A) influencing any act or decision of such party, official, or candidate in its or his official capacity, including a decision to fail to perform its or his official functions; or

"(B) inducing such party, official, or candidate to use its or his influence with a foreign government or instrumentality thereof to affect or influence any act or decision of such government or instrumentality,

in order to assist such issuer in obtaining or retaining business for or with, or directing business to, any person; or

"(3) any person, while knowing or having reason to know that all or a portion of such money or thing of value will be offered, given, or promised, directly or indirectly, to any foreign official, to any foreign political party or official thereof, or to any candidate for foreign political office, for purposes of—

"(A) influencing any act or decision of such foreign official, political party, party official, or candidate in his or its official capacity, including a decision to fail to perform his or its official functions; or

"(B) inducing such foreign official, political party, party official, or candidate to use his or its influence with a foreign government or instrumentality thereof to affect or influence

APPENDIX 8

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1976

94th Congress }
2d Session }

COMMITTEE PRINT

REPORT

OF THE

SECURITIES AND EXCHANGE COMMISSION

ON

QUESTIONABLE AND ILLEGAL CORPORATE PAYMENTS AND PRACTICES

SUBMITTED TO THE

COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS

UNITED STATES SENATE

MAY 1976

Printed for the use of the Committee on Banking, Housing and Urban Affairs

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U.S. GOVERNMENT PRINTING OFFICE

71-389 O WASHINGTON : 1976

REPORT OF THE SECURITIES AND EXCHANGE COMMISSION ON QUESTIONABLE AND ILLEGAL CORPORATE PAYMENTS AND PRACTICES

SUBMITTED TO THE
SENATE BANKING, HOUSING AND URBAN AFFAIRS COMMITTEE
May 12, 1976

INTRODUCTION

In a letter dated March 18, 1976, to Chairman Proxmire, Chairman Hills offered to provide a detailed analysis of information concerning illegal or questionable foreign payments contained in public documents filed with the Securities and Exchange Commission. The following sets forth that report.

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 a 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. Millions of dollars of funds have been inaccurately recorded in corporate books and records to facilitate the making of questionable payments. Such falsification of records has been known to corporate employees and often to top management, but often has been concealed from outside auditors and counsel and outside directors.

Accordingly, the primary thrust of our actions has been 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.

To this end we have sought independent review of past disclosure in our enforcement actions and in our voluntary disclosure program; we have requested the auditing profession to review its procedures and to make suggestions for dealing with the problem and we have asked the New York Stock Exchange and others to consider helping us strengthen the ability and resolve of the boards of our major corporations to act independently of operating management.

Part I of this report provides a description of the Commission's activities in this area, as well as an analysis of public information that has been disclosed as a result of these activities and of the response of the private sector to the problems we have identified.

Part II contains the Commission's analysis of, and recommendations with respect to, S. 3133, as well as its legislative proposal to deal with the matter of questionable and illegal corporate payments and a description of further actions taken by the Commission to encourage corporate accountability in this area.

In order to restore the integrity of the disclosure system and to make corporate officials more fully accountable to their boards of directors and shareholders, the Commission's basic approach has been twofold:

-- To insure that investors and shareholders receive material facts necessary to make informed investment decisions and to assess the quality of management; and

-- To establish a climate in which corporate management and the professionals that advise them become fully aware of these problems and deal with them in an effective and responsible manner.

The Commission is confident that its legislative proposals and the suggestions contained in Part II of this report will help foster a climate that will rectify many of the problems we have identified.

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PART I: THE COMMISSION'S ACTIVITIES AND CONCLUSIONS

A synopsis of the public filings made with the Commission has been assembled in tabular form, attached as Exhibit A. The Commission's staff, in preparing these tables, has analyzed the public disclosures filed with it by 89 corporations as of April 21, 1976, that refer to questionable or illegal foreign and domestic payments and practices. In addition, the staff has prepared summaries of the six special reports obtained as a result of our enforcement actions, attached as Exhibit B. Finally, we also have included as part of Exhibit B a description of the allegations made in eight other enforcement actions in which we have obtained judicial relief but where reports have not been completed or, in one instance, will not be required.

The tremendous variation in the types and amounts of payments and the attendant circumstances disclosed in the reports filed with the Commission make categorization or quantification of the extent and seriousness of the problem of questionable or illegal foreign payments difficult. Accordingly, we recognize that the matters reported in these exhibits may lead others to conclusions

concerning the nature, extent and seriousness of the problem that differ from our own. The Commission, therefore, is providing the Committee a copy of each of the underlying public documents on which our analysis is based so that Committee can reach its own determinations, where appropriate.

A. Sources of Information: The Commission's Disclosure and Enforcement Programs

Before considering the extent of the problem of questionable or illegal foreign payments, it would be helpful to describe the nature of the disclosure system and the enforcement efforts that produced the information set forth in the Exhibits.

1. Enforcement Program

In 1973, as a result of the work of the Office of the Special Prosecutor, several corporations and executive officers were charged with using corporate funds for illegal domestic political contributions. The Commission recognized that these activities involved matters of possible significance to public investors, the nondisclosure of which might entail violations of the federal securities laws. On March 8, 1974, the Commission therefore published a statement

expressing the view of its Division of Corporation Finance concerning disclosure of these matters in public filings. 1/

The Commission's inquiry into the circumstances surrounding alleged illegal political campaign contributions revealed that violations of the federal securities laws had indeed occurred. The staff discovered falsifications of corporate financial records, designed to disguise or conceal the source and application of corporate funds misused for illegal purposes, as well as the existence of secret "slush funds" disbursed outside the normal financial accountability system. These secret funds were used for a number of purposes, including in some instances, questionable or illegal foreign payments. These practices 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.

The resulting investigations culminated in the institution of injunctive actions against nine corporations during the one-year period following the Spring of 1974. Subsequently other cases were brought involving questionable or illegal foreign and domestic payments and practices. Details of the facts alleged and ultimately established in these enforcement actions are contained in Exhibit B.

1/ Securities Act Release No. 5466 (Mar. 8, 1974).

of the reports submitted voluntarily by corporations, the description of the payments and their documentation appears to have been inadequate to permit ready identification or verification of the purpose of the payments. Similarly, the reports the Commission obtained as a result of enforcement actions disclose flagrant instances of abuse of the system of corporate accountability, including the establishment and maintenance of substantial off-book funds that were used for various purposes, some questionable and some clearly illegal.

Many of the defects and evasions of the system of financial accountability represented intentional attempts to conceal certain activities. Not surprisingly, corporate officials are unlikely to engage in questionable or illegal conduct and simultaneously reflect it accurately on corporate books and records. We regard this to be a significant point, and one that is central to the approach we outline in Part II of this report.

Finally, although it is not possible to draw definitive conclusions regarding the possible impact of cessation of the practices reported on the foreign commercial activities of the companies that reported them, the indications in our data suggest that it will not seriously affect the ability of American business to compete in

world markets. Nineteen of the companies reporting questi able or illegal payments or practices specifically noted t cessation of the practices would have no material effect o their total revenues or overall business. Generally, it has not been suggested that cessation would seriously hamp companies' overall operations.

On the other hand, it is not possible to determine the amount of business associated with each of the reporte payments. The volume of sales or other revenues reported b some companies to be "related" to the practices ranged fro 20 to in well in excess of 100 times the amount of the pay themselves. One cannot determine whether some or all of t revenues could or would have been obtained without the pay or practices.

E. THE RESPONSE OF THE PRIVATE SECTOR

The Commission has attempted to ascertain the atti of the business and accounting communities to the problems recently revealed in this area. We regard this to be a cr factor in dealing with these problems. The Commission, wi its limited resources, must maximize its own effectiveness by constantly seeking to prompt the private sector's incre assumption of initiative and responsibility in dealing wit

payments to be proper, and indicates that they were not bribes or attempts to obtain preferential treatment. Furthermore, it is attempting to arrange for such foreign governments to publish recognition of and procedures for these payments.

3. The Response of the Accounting Community

Many of the instances of improper or illegal foreign payments examined by the Commission have involved cases in which inadequate or improper corporate books and records concealed the existence of these questionable payments from the independent auditors, as well as from some or all of the members of top management and the board of directors. Some cases also involved the maintenance of funds outside the normal accountability system for similar purposes. In a number of cases, these falsifications or inadequacies have been deliberate, and represented careful attempts of some corporate executives or members of the board of directors to conceale their activities from the auditors, other company officials and members of the board. In many instances, defects in the corporate accountability system were instituted at lower levels in the corporate hierarchy.

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.

One of the most important by-products of the Commission' program to ensure adequate discovery and disclosure of questior able and illegal payments has been the increased sensitivity demonstrated by the accounting community. The independent accountant's responsibility is to certify that the financial statements of a corporation are fairly presented in accordance with generally accepted accounting principles. Accountants are not free to close their eyes to facts that come to their attention, and in order properly to satisfy their obligations, they must be reasonably sure that corporate books and records are free from defects that might compromise the validity of these statements.

In many respects, both the Commission's and the public's awareness of the magnitude and implications of the problems presented by questionable and illegal foreign payments has been evolutionary. The accounting community has become more sensitive to this evolution. And, although the responses of the accounting system have varied from firm to firm, the overall response of the profession is encouraging. An informal survey undertaken by our Chief Accountant indicates that the following are representative of the policies and procedures adopted by the accounting profession in response to the problems we have identified.

over the long run. This optimism rests both on the declarations of cessation, already mentioned, and, more fundamentally, on the "new governance" concept that the Commission's enforcement and disclosure programs are attempting to instill and its legislative and other proposals are designed to enhance.

Thus, in the Commission's view, while the problem of questionable or illegal corporate payments is both serious and widespread, it can be controlled and does not represent an inherent defect in our economic system. While the Committee may wish to draw its own conclusions from the analysis we have supplied, hopefully the foregoing comments concerning the patterns the Commission perceives in these data and the conclusions it draws from them, will provide a useful starting point.

PART II: LEGISLATIVE AND OTHER PROPOSALS

A. Discussion

As the foregoing discussion makes clear, the Commission has proceeded to apply its existing disclosure requirements to matters brought to its attention involving questionable or illega corporate payments. While we have not felt hampered in our enforcement efforts to date, the fact nevertheless remains that the extent of such payments is far more widespread than anyone originally anticipated, and the methods of effecting and concealing these payments are varied and multifaceted. The Commission can, and intends to, continue to enforce its existing disclosure requirements in those cases which appear to warrant enforcement action to compel disclosures about corporate operations involving such payments.

But, the question of illegal or questionable payments is obviously a matter of national and international concern, and the Commission, therefore, is of the view that limited-purpose legislation in this area is desirable in order to demonstrate clear Congressional policy with respect to a thorny and controversial problem. For this reason, the Commission wholeheartedly supports the philosophy underlying S. 3133, although we have drafted a modified version of that bill as a preferable legislative approac to the issues raised in this area.

In essence, we see three critical components for any legislative enactment governing the disclosure or making of

illegal or questionable corporate payments.

First, we believe that any legislation in this area should embody a prohibition against the falsification of corporate accounting records. The most devastating disclosure that we have uncovered in our recent experience with illegal or questionable payments has been the fact that, and the extent to which, some companies have falsified entries in their own books and records. 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.

Concomitantly, we believe that any legislation in this area should also contain a prohibition against the making of false and misleading statements by corporate officials or agents to those persons conducting audits of the company's books and records and financial operations.

Finally, we believe that any legislation should require management to establish and maintain its own system of internal accounting controls designed to provide reasonable assurances that corporate transactions are executed in accordance with

management's general or specific authorization; and that such transactions as are authorized are properly reflected on the corporation's books and records in such a manner as to permit the preparation of financial statements in conformity with generally accepted accounting principles or any other criteria applicable to such statements.

The concept of internal accounting controls is not new. It has been recognized by the accounting profession as being an important responsibility of management. Because the accounting profession has defined the objectives of a system of accounting control, the Commission has taken the definition of the objective of such a system contained in our proposed legislation from the authoritative accounting literature. American Institute of Certified Public Accountants, Statement on Auditing Standards No. 1, 320.28 (1973). The Commission is satisfied that the specifications of the objectives of a system of internal accounting controls found in the accounting literature can be readily understood by issuers and accountants. Because the dominant characteristic observed by the Commission in its program has been the presence of deliberate evasions of the systems of corporate accountability, the Commission believes that its proposed legislative approach will help foster a climate in which such attempts will be frustrated by adequate internal controls. No system can insure or guarantee complete success, but the Commission believes its approach is the appropriate one to address the problems we have observed.

of such legislation upon the foreign relations of the United States.[36/] In this context the purposes of the federal securities laws, while important, are not the only or even the overriding consideration, and we believe that the issue should be considered separately from the federal securities laws.

Finally, Section 4 of S. 3133 would give the Commission authority to initiate, prosecute and appeal criminal actions arising under any of the provisions of the Securities Act of 1933 and the Securities Exchange Act of 1934. Whether or not this provision has merit as a general policy proposition, we think that it would be unwise to divert attention from the critical policy issues posed by S. 3133 to what, in the context of this legislation, must surely be characterized as a peripheral issue. We prefer that any such provision be contained in separate legislation, at a time when full and careful debate could be had on its merits.

36/ See "The Activities of American Multinational Corporations Abroad." Hearings before the Subcomm. on International Economic Policy of the House Comm. on International Relations, 94th Cong., 1st Sess., 23-24 (1975), where a representative of the Department of State suggested that such legislation "would be widely resented abroad" and could be viewed by other governments . . . "as a sign of U.S. arrogance or even as interference in their internal affairs."

B. Draft Legislation Proposed by the Commission

The Commission proposes the following for Congressional consideration:

A BILL

To amend the Securities Exchange Act of 1934 to prohibit certain issuers of securities from falsifying their books and records, and for related purposes.

Be it enacted by the Senate and House of Representative of the United States of America in Congress assembled,

That Section 13(b) of the Securities Exchange Act, 15 U.S.C. 78m(b), is amended by renumbering existing Section 13(b) as "Section 13(b)(1)", and by adding at the end of new Section 13(b)(1), the following subparagraphs:

"(b)(2) Every issuer which has a class of securities registered pursuant to section 12 of this title and every issuer which is required to file reports pursuant to Section 15(d) of this title shall

"(A) make and keep books, records and accounts, which accurately and fairly reflect the transactions and dispositions of the assets of the issuer; and

"(B) devise and maintain an adequate system of internal accounting controls sufficient to provide reasonable assurances that

"(i) transactions are executed in accordance with management's general or specific authorization;

"(ii) transactions are recorded as necessary (1) to permit preparation of financial statements in conformity with generally accepted accounting principles or any other criteria applicable to such statements and (2) to maintain accountability for assets;

"(iii) access to assets is permitted only in accordance with management's authorization; and

"(iv) the recorded accountability for assets is compared with the existing assets at reasonable intervals and appropriate action is taken with respect to any differences.

"(b)(3) It shall be unlawful for any person, directly or indirectly, to falsify, or cause to be falsified, any book, record, account or document, made or required to be made for any accounting purpose, of any issuer which has a class of securities registered pursuant to section 12 of this title or which is required to file reports pursuant to Section 15(d) of this title.

"(b)(4) It shall be unlawful for any person, directly or indirectly,

"(A) to make, or cause to be made, a materially false or misleading statement, or

"(B) to omit to state, or cause another person to omit to state, any material fact necessary in order to make statements made, in the light of the circumstances under which they were made, not misleading

to an accountant in connection with any examination or audit of an issuer which has a class of securities registered pursuant to section 12 of this title or which is required to file reports pursuant to Section 15(d) of this title, or in connection with any examination or audit of an issuer with respect to an offering registered or to be registered under the Securities Act of 1933."

C. Section-by-Section Analysis of Commission's Proposed Legislation

The proposal amends Section 13(b) of the Securities Exchange Act, 15 U.S.C. 78m(b) by adding new subsections (b)(2), (b)(3) and (b)(4).

Subsection (b)(2) would apply to issuers which have securities listed on an exchange pursuant to Section 12(b) of the Securities Exchange Act, 15 U.S.C. 78l(b), to issuers which meet the requirements of Section 12(g) of that Act, 15 U.S.C. 78l(g), and to issuers subject to the reporting requirements of Section 15(d) of the Act, 15 U.S.C. 78o(d). This subsection imposes an obligation on these issuers both to maintain books and records which accurately and fairly reflect the transactions and the dispositions of the assets of the issuers, and to devise and maintain an adequate system of internal accounting controls sufficient to provide reasonable assurances that, among other things, transactions are recorded as necessary to permit the preparation of financial statements in conformity with genera[l] accepted accounting principles or any other applicable criter[ia]. Because the accounting profession has defined the objectives of a system of accounting control, the definition of the objectives contained in this subsection is taken from the authoritative accounting literature. American Institute of Certified Public Accountants, Statement on Auditing Standards No. 1, 320.28 (1973).

APPENDIX 9

95th Congress 1st Session	} SENATE {	Report No. 95-114

FOREIGN CORRUPT PRACTICES AND

DOMESTIC AND FOREIGN INVESTMENT IMPROVED DISCLOSURE ACTS OF 1977

REPORT

of the

COMMITTEE ON BANKING, HOUSING,

AND URBAN AFFAIRS

UNITED STATES SENATE

to accompany

S. 305

together with

ADDITIONAL VIEWS

May 2 (legislative day, March 28), 1977. - Ordered to be printed

The Committee on Banking, Housing and Urban Affairs favorably reports a bill (S. 305) to amend the Securities Exchange Act of 1934 to require companies subject to the jurisdiction of the Securities and Exchange Commission to maintain accurate records, to prohibit certain bribes, to expand and improve disclosure of ownership of the securities of U.S. companies, and for other purposes, and recommends that the bill, as amended by the committee, do pass.

History of the Bill

During the 94th Congress, the Committee on Banking, Housing and Urban Affairs held extensive hearings on the

matter of improper payments to foreign government officials by American corporations. The committee also considered several bills designed to deal with the problem in various ways including S. 3133 introduced by Senator Proxmire on March 11, 1976; S. 3379 introduced by Senators Church, Clark and Pearson on May 5, 1976, and S. 3418 introduced by Senator Proxmire at the request of the Securities and Exchange Commission (SEC) on May 12, 1976.

On May 12, 1976, the committee received from the SEC an extensive "Report on Questionable and Illegal Corporate Payments and Practices," ("SEC report") which summarized the SEC's enforcement activities and findings to that date. That report traced the history of the Commission's discovery of conduct involving the misuse of corporate funds and the commencement of investigations which subsequently revealed that instances of undisclosed questionable or illegal [*page 2*] corporate payments were indeed widespread and represented a serious breach in the operation of the Commission's system of corporate disclosure and, correspondingly, in public confidence in the integrity of the system of capital formation. The SEC report also analyzed the public filings of 89 corporations that had disclosed varying types of questionable payments, plus six special reports obtained as the result of SEC enforcement actions and the allegations made in eight additional cases in which the SEC had obtained some form of judicial relief. Finally, the report contained the SEC's analysis of the degree of disclosure required concerning questionable foreign payments under the existing Federal securities laws and outlined the legislative and other responses which the Commission recommended to remedy these problems.

On June 22, 1976, the committee met and ordered reported a bill, S. 3664, which incorporated the SEC's recommendations and a direct prohibition against the payment of overseas bribes by any U.S. business concern. (1) On September 15, 1976, the Senate, by a unanimous vote of 86-0 passed S. 3664. The House of Representatives, however, did not complete work on that legislation before its adjournment on October 2, 1976.

Title II of S. 305, which would amend the Federal securities laws to enhance the present system of disclosure of the ownership of American business, has also been the subject of numerous hearings and careful deliberation by the committee in the past. Last year, as part of S. 3084, the committee reported favorably (2) and the Senate passed the disclosure provisions as title III of S. 3084. No final action was taken by the Congress on this bill prior to adjournment either.

Shortly after the 95th Congress convened on January 18, 1977, Senators Proxmire and Williams introduced S. 305. As introduced, title I of the bill was identical to S. 3664, the measure which the Senate had passed unanimously during the prior Congress and title II was substantially the same as Title II of S. 3084.

The committee held hearing on S. 305 on March 16, 1977, and received testimony from Senator Metcalf, the Securities and Exchange Commission, the Department of the Treasury, the American Bankers Association, and the Securities Industry Association. Subsequently, on April 7, 1977, the committee met in open session to consider S. 305. The committee ordered the bill, with an amendment, to be reported to the Senate.

Summary of the Bill

a. title i - corporate bribery of foreign officials

Title I of S. 305 is designed to prevent the use of corporate funds for corrupt purposes. As reported, Title I:

- Requires companies subject to the jurisdiction of the SEC to maintain strict accounting standards and management control over their assets;
- Prohibits the falsification of accounting records and the deceit of accountants auditing, the books and records of such companies; and [*page 3*]
- Makes it a crime for U.S. companies to bribe a foreign government official for the specified corrupt purposes. Companies violating the criminal prohibitions face maximum fines of $500,000. Individuals acting on behalf of such companies face a maximum fine of $10,000 and 5 years in jail.

In the past, corporate bribery has been concealed by the falsification of corporate books and records. Title I removes this avenue of coverup, reinforcing the criminal sanctions which are intended to serve as the significant deterrent to corporate bribery. Taken together, the accounting requirements and criminal prohibitions of Title I should effectively deter corporate bribery of foreign government officials.

b. title ii - improved disclosure of corporate ownership

[*OMITTED*]

Need for Legislation

a. title i - corporate bribery of foreign officials

Recent investigations by the SEC have revealed corrupt foreign payments by over 300 U.S. companies involving hundreds of millions of dollars. These revelations have had severe adverse effects. Foreign governments friendly to the United States in Japan, Italy, and the Netherlands have come under intense pressure from their own people. The image of American democracy abroad has been tarnished. Confidence in the financial integrity of our corporations has been impaired. The efficient functioning of our capital markets as been hampered.

[*page 4*] Corporate bribery is bad business. In our free market system it is basic that the sale of products should take place on the basis of price, quality, and service. Corporate bribery is fundamentally destructive of this basic tenet. Corporate bribery of foreign officials takes place primarily to assist corporations in gaining business. Thus foreign corporate bribery affects the very stability of overseas business. Foreign corporate bribes also affect our domestic competitive climate when domestic firms engage in such practices as a substitute for healthy competition for foreign business.

Managements which resort to corporate bribery and the falsification of records to enhance their business reveal a lack of confidence about themselves. Secretary of the Treasury Blumenthal, in appearing before the committee in support of the criminalization of foreign corporate bribery testified that: "Paying bribes - apart from being morally repugnant and illegal in most countries - is simply not necessary for the successful conduct of business here or overseas."

The committee concurs in Secretary Blumenthal's judgment. Many U.S. firms have taken a strong stand against paying foreign bribes and are still able to compete in international trade. Unfortunately, the reputation and image of all U.S. businessmen has been tarnished by the activities of a sizable number, but by no means a majority of American firms. A strong antibribery law is urgently needed to bring these corrupt practices to a halt and to restore public confidence in the integrity of the American business system.

b. title ii - disclosure of corporate ownership

[*OMITTED*]

[*page 7*]

Nature of Legislation

a. title i - corporate bribery of foreign officials

1. Accurate accounting

The committee recognizes that the SEC has broad authority to promulgate accounting standards for companies subject to jurisdiction under its existing authority. Nevertheless, the committee believes the Commission's current program for accurate accounting should be supplemented by an explicit statement of statutory policy. The accounting standards in S. 305 are intended to operate in tandem with the criminalization provisions of the bill to deter corporate bribery. S. 305 expresses a public policy which encompasses a unified approach

to the matter of corporate bribery.

This legislation imposes affirmative requirements on issuers to maintain books and records which accurately and fairly reflect the transactions of the corporation and to design an adequate system of internal controls to assure, among other things, that the assets of the issuer are used for proper corporate purpose. The committee believes that the imposition of these affirmative duties under our securities laws coupled with attendant civil liability and criminal penalties for failure to comply with the statutory standard will go a long way to prevent the use of corporate assets for corrupt purposes. Public confidence in securities markets will be enhanced by assurance that corporate recordkeeping is honest.

Section 102 of the bill as reported amends section 13(b) of the Securities Exchange Act by adding new paragraphs (b)(2), (b)(3), (b)(4), and (b)(5). The provisions of section 102 apply to issuers which have securities listed on an exchange pursuant to subsection 12(b) of the Securities Exchange Act, to issuers which meet the requirements of section 12(g) of that Act, and to issuers subject to the reporting requirement of section 15(d) of the Act.

The purpose of section 102 is to strengthen the accuracy of the corporate books and records and the reliability of the audit process which constitute the foundations of our system of corporate disclosure. Section 102 substantially embodies the measures which the SEC recommended to the committee in its May 22, 1976, report on questionable payments. New subparagraph (b)(2)(A) imposes an obligation on issuers to maintain books and records that accurately and fairly reflect transactions and dispositions of the assets of the issuers. (3)

Subparagraph (b)(2)(B) would require issuers to devise and maintain an adequate system of internal accounting controls sufficient to [*page 8*] provide reasonable assurances that, among other things, transactions are recorded as necessary to permit the preparation of financial statements in conformity with generally accepted accounting principles or any other applicable criteria. Because the accounting profession has defined the objectives of a system of accounting control, the definition of the objectives contained in this subparagraph is taken from the authoritative accounting literature. *See* American Institute of Certified Public Accountants, Statement on Auditing Standards No. 1, 320.28 (1973).

The establishment and maintenance of a system of internal controls is an important management/obligation [*sic*]. A fundamental aspect of management's stewardship responsibility is to provide shareholders with reasonable assurances that the business is adequately controlled. Additionally, management has a responsibility to furnish shareholders and potential investors with reliable financial information on a timely basis. An adequate system of internal accounting controls is necessary to management's discharge of these obligations.

The committee understands that auditors customarily provide management with comments on the state of the client's internal controls. Those comments are designed to assist the issuer in improving its system of internal controls and thereby to assist the auditor in the conduct of its audit. The committee recognizes that no system of internal controls is perfect, and that there will always be room for improvement. Auditor's comments and suggestions to management on possible improvements are to be encouraged.

The establishment and maintenance of a system of internal control and accurate books and records are fundamental responsibilities of management. The expected benefits to be derived from the conscientious discharge of these responsibilities are of basic importance to investors and the maintenance of the integrity of our capital market system. The committee recognizes, however, that management must exercise judgment in determining the steps to be taken, and the cost incurred, in giving assurance that the objectives expressed will be achieved. Here, standards of reasonableness must apply. In this regard, the term "accurately" does not mean exact precision as measured by some

abstract principle. Rather it means that an issuer's records should reflect transactions in conformity with generally accepted accounting principles or other applicable criteria. While management should observe every reasonable prudence in satisfying the objectives called for in new paragraph (2) of section 13(b), the committee recognizes that management must necessarily estimate and evaluate the cost/benefit relationships of the steps to be taken in fulfillment of its responsibilities under this paragraph. The accounting profession will be expected to use their professional judgment in evaluating the systems maintained by issuers. 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.

- *Prohibition against falsification of accounting records and deception of auditors*

Paragraph (b)(3) would make it unlawful for any person, directly or indirectly, knowingly to falsify any book, record or account main[*page 9*]tained, or required to be maintained, for an accounting purpose of an issuer subject to paragraph (b)(2) of section 13 of the Securities Exchange Act of 1934. This paragraph covers both actions of commission and omission.

Paragraph (b)(4) would prohibit knowingly making false or misleading statements, or knowingly omitting to state facts necessary to be stated, to an accountant in connection with an audit or examination of issuers identified in paragraph (b)(2) of section 13 of the Securities Exchange Act. This paragraph would also apply to audits in connection with a securities offering registered or to be registered under the Securities Act of 1933. Concepts of aiding and abetting are applicable to conduct covered by these sections. By specifically prohibiting the making of knowingly materially false or misleading statements or omissions to auditors, the bill is designed to encourage careful communications between the auditors and persons from whom the auditors seek information in the audit process. The committee is of the view that a proscription on knowing false statements to auditors will enhance the integrity of the auditing process.

The amendments to section 13(b) prohibiting the falsification of corporate books and records and the making of misleading representations to auditors are not intended to make unlawful conduct which is merely negligent. To clarify the purpose of these paragraphs, therefore, the committee inserted the term "knowingly" in appropriate places in both paragraphs (3) and (4). As explained to the committee, the term "knowingly" connotes a "conscious undertaking" Thus these paragraphs proscribe and make unlawful conduct which is rooted in a conscious undertaking to falsify records or mislead auditors through a statement or conscious omission of material facts.

The committee believes that the inclusion of the "knowingly" standard is appropriate because of the danger, inherent in matters relating to financial recordkeeping, that inadvertent misstatements or minor discrepancies arising from an unwitting error in judgment might be deemed actionable. The committee does not, however, intend that the use of the terming [*sic*] "knowingly" will provide a defense for those who shield themselves from the facts. The knowledge required is that the defendant be aware that he is committing the act which is false not that he know that his conduct is illegal. The inclusion of this standard is intended to be limited to matters arising under these new subsections and not to any other provisions of the securities laws. As a result, in this limited instance, in order to prove that falsification of corporate accounting records or deception of auditors is "knowingly" committed, the Commission will be required to establish this element in actions arising under new paragraphs 13(b)(3) and 13(b)(4).

The knowledge required is that the person be aware that he is or may be making a false statement or causing corporate records to be falsified through a conscious undertaking or due to his conscious disregard for the truth.

The bill, as reported, would also permit the head of any agency or department responsible for national security matters to exempt, on a limited basis, an issuer involved in an endeavor related to national security from the accounting and reporting requirements of the bill. The facts and circumstances to which the directive applies must be reported to the President. [*page 10*]

3. Criminalization of foreign bribery

The committee recognizes that the SEC has diligently sought to enforce the existing provisions of the Federal securities laws by requiring corporate reports to disclose "material" payments. Nevertheless, the committee has concluded that - "The serious abuses which the Commission has uncovered justify an explicit congressional affirmation of our national commitment of ending corrupt foreign payments. While the Commission has made substantial progress in its enforcement program, the committee believes that legislation is appropriate to make clear that cessation of these abuses is a matter, not merely of SEC concern, but of national policy."

Secretary of the Treasury Blumenthal supported the criminalization of overseas bribery in testimony before the committee. The committee considered the matter extensively in the 94th Congress and concluded that the criminalization approach was preferred over a disclosure approach. Direct criminalization entails no reporting burden on corporations and less of an enforcement burden on the Government. The criminalization of foreign corporate bribery will to a significant extent act as a self- enforcing, preventative mechanism.

Sections 103 and 104 of the bill provide criminal penalties for foreign corrupt bribery. Section 103 applies to issuers and reporting firms under the jurisdiction of the SEC. Section 104 applies to all other domestic concerns. Under sections 103 and 104, a corporation is prohibited from making payments to a foreign official for the purpose of inducing him to obtain or retain business for the corporation or to influence legislation or regulations of the Government.

Payments to officials of a foreign political office [*sic*] having the purposes set forth respecting payments to foreign government officials are likewise proscribed. And payments to agents, while knowing or having reason to know, that all or a portion of the payment will be offered or given to a foreign government official, foreign political party or candidate for foreign political office for the proscribed purposes are also forbidden.

The statute covers payments made to foreign officials for the purposes of obtaining business or influencing legislation or regulations. The statue does not, therefore, cover so-called "grease payments" such as payments for expediting shipments through customs or placing a transatlantic telephone call, securing required permits, or obtaining adequate police protection, transactions which may involve even the proper performance of duties.

The word "corruptly" is used in order to make clear that the offer, payment, promise, or gift, must be intended to induce the recipient to misuse his official position in order to wrongfully direct business to the payor or his client, or to obtain preferential legislation or a favorable regulation. The word "corruptly" connotes an evil motive or purpose, an intent to wrongfully influence the recipient. It does not require that the act be fully consummated, or succeed in producing the desired outcome.

Sections 103 and 104 cover payments and gifts intended to influence the recipient, regardless of who first suggested the payment or gift. The defense that the payment was demanded on the part of a government official as a price for gaining entry into a market or to obtain a contract would not suffice since at some point the U.S. company would make a conscious decision whether or not to pay a bribe. That [*page 11*] the payment may have been first proposed by the recipient rather than the U.S. company does not alter the corrupt purpose on the part of the person paying the bribe. On the other hand true extortion situations would not be covered by this provision since a payment to an official to keep an oil rig from being dynamited should not be held to be made with the requisite corrupt purposes.

Section 305 as reported also covers the officers, directors, employees, or stockholders making overseas bribes on behalf of the corporation. This provision is intended to make clear that it is corporate or business bribery which is being proscribed. Whether or not a particular situation involves bribery by the corporation or by an individual acting on his own will depend on all the facts and circumstances, including the position of the employee, the care with which the board of directors supervises management, the care with which management supervises employees in sensitive positions and its adherence to the strict accounting standards set forth under section 102. The prohibitions against corrupt payments apply in this regard to payments by agents where the corporation paying them knew or had reason to know they would be passed on in whole or in part to a foreign government official for a proscribed purpose. Of course, where the corporation knows the payment will be passed on for a proscribed purpose, the violation is complete.

The committee has recognized that the bill would not reach all corrupt overseas payments. For example, the bill would not cover payments by foreign nationals acting solely on behalf of foreign subsidiaries where there is no nexus with

U.S. interstate commerce or the use of U.S. mails and where the issuer, reporting company, or domestic concern had no knowledge of the payment. But a U.S. company which "looks the other way" in order to be able to raise the defense that they were ignorant of bribes made by a foreign subsidiary, could be in violation of section 102 requiring companies to devise and maintain adequate accounting controls. Under the accounting section no off-the-books accounting fund could be lawfully maintained, either by a U.S. parent or by a foreign subsidiary, and no improper payment could be lawfully disguised.

4. Enforcement responsibilities

After careful consideration the committee concluded that the SEC should continue to have a role in the investigation of violations of the criminal prohibitions as they apply to companies under the jurisdiction of the SEC. The SEC has been the principal agency of the Government taking the lead in the investigation of foreign bribery. This is as it should be for the bribery of foreign officials often violates our securities laws to the extent the payment is not disclosed to investors. The SEC has thus developed considerable expertise in investigation [*sic*] corrupt overseas payments. This same expertise can be put to work in investigating potential violations of the antibribery provisions of this legislation. If this investigative responsibility were to be assigned solely to the Justice Department, as some had advocated, that agency would have to duplicate the investigative capability already in the SEC at a greater cost to the Government.

It should be emphasized that while the SEC investigates potential violations of the securities laws, the only remedy it can bring on its own is an injunctive action. When the SEC believes it has compiled enough evidence for a criminal action, it refers the case to the Justice [*page 12*] Department for criminal prosecution. This same division of responsibility would also apply with respect to the antibribery provisions of this legislation.

The committee believes this division of responsibility will result in a stronger enforcement effort compared to an exclusive assignment to the Justice Department. It is often difficult to assemble the degree of evidence required in a criminal action, but enough evidence may exist to enable the SEC to halt a continuation of the corrupt practices through an injunctive action.

The committee expects that close cooperation will develop between the SEC and the Justice Department at the earliest stage of any investigation in order to insure that the evidence needed for a criminal prosecution does not become stale. The arrangements which the committee expects the SEC and Justice to work out on criminal matters is in no way intended to cast doubt upon the authority of the SEC to prosecute and defend its own civil litigation. Under the bill, the Justice Department retains sole investigative and prosecutional jurisdiction over domestic concerns covered but which are not otherwise within the jurisdiction of the SEC.

The committee believes that, by assigning to the SEC enforcement responsibilities for the new prohibition, it will strengthen the Commission's ability to enforce compliance with the existing requirements of the securities laws, and with the new accounting provisions recommended by the Commission and included as section 102 of the bill. Obviously, there may be practical impediments to enforcement in individual cases, just as proof of bribery and other white collar crimes is often difficult to obtain in domestic cases. Nonetheless, the Commission's enforcement efforts under existing U.S. law demonstrate that it is entirely feasible for U.S. agencies successfully to investigate improper foreign payments made on behalf of American corporations.

The SEC's responsibilities would extend to conducting investigations, bringing civil injunctive actions, commencing administrative proceedings if appropriate, (4) defending lawsuits against the Commission and its staff arising out of the Commission's obligations under this Act, and referring cases to the Justice Department for criminal prosecution on a timely basis. The Commission, of course, will retain all of its existing remedies under the securities laws, and the committee anticipates that the Commission will continue to tailor remedies to fit the circumstances of specific cases.

b. title ii - disclosure of corporate ownership

[*OMITTED*]

[*page 16*]

Section-by-section Analysis

The purpose of this legislation would be accomplished by amending existing sections 13(b), 13(d), 15(d), and 32(a) of the Securities Exchange Act of 1934 ("the act") and by adding new sections 13(g), 13(h), and new section 30A, to the act. Further, a new provision would be added to the criminal code.

a. title i - foreign corrupt practices

Short title

Section 101. This title may be cited as the "Foreign Corrupt Practices Act of 1977."

Integrity of accounting records and reports

Section 102 of the bill would amend section 13 of the Exchange Act by renumbering exiting subsection (b) as (b)(1) and by adding four new paragraphs. New paragraph 13(b)(2) would apply only to issuers which have a class of securities registered pursuant to section 12 of the act and issuers required to file reports pursuant to section 15(d) of the act ("reporting companies"). It would require reporting companies to make and keep books, records, and accounts which accurately and fairly reflect all of their transactions and dispositions of assets.

A reporting company also would be required to establish and maintain an adequate system of internal accounting controls sufficient to provide reasonable assurances that:

- Transactions are executed in accordance with management directions;
- Transactions are recorded in a manner that permits the company to prepare its financial statements in accordance with generally accepted accounting principles or other applicable criteria and to maintain accountability for its assets;
- Access to company assets is permitted only in accordance with management authorization; and
- The recorded accountability for assets is compared with existing assets at reasonable intervals and appropriate action is taken with respect to differences.

New paragraph (3) would make it unlawful for any person knowingly to make or cause to be made a materially false or misleading statement or to omit to state or cause another person to omit to state any material fact necessary in order to make statements to accountant not misleading. This paragraph would apply to statements made to an accountant in connection with any examination or audit of an issuer with securities registered under the Securities Act of 1933, as well as any examination or audit of a reporting company. [*page 17*]

New paragraph (5) would provide that no duty or liability could be imposed under new paragraphs (2), (3), or (4) upon any person acting pursuant to a written directive of the head of an agency responsible for national security. This exclusion only applies, however to the extent that the requirements of new paragraphs (2), (3), or (4) would be likely to result in the disclosure of properly classified national security information. Every directive executed by a national security agency head under this paragraph would have to describe specifically the facts which are not to be disclosed and the surrounding circumstances. These directives would expire annually unless renewed in writing. Agency heads would maintain a file of these directives, and each year on October 1 all directives in force during the prior year would have to be transmitted to the President for his review and certification that all conformed to law.

Prohibition against certain payments to officials by registered companies

Section 103 of the bill would add a new section 30A to the Act to prohibit any reporting company, or any officer, director, or employee, or shareholder acting on behalf of such a company, to use the mails or the means or

instrumentalities of interstate commerce corruptly in furtherance of an offer, payment, or promise to pay, or authorization of the payment of, any money, offer, gift, or promise to give anything of value, to three classes of persons:

- An official of a foreign government or instrumentality of a foreign government,
- A foreign political party or an official of a foreign political party, or a candidate for a foreign political office, or
- Any other person while the issuer knows or has reason to know that money or a gift will be offered, promised or given to an official of a foreign political party, or a candidate for a foreign political office.

The scope of section 30A is limited by the requirement that the offer, promise authorization, payment, or gift must have as a purpose inducing the recipient to use influence with the foreign government or instrumentality, or to refrain from performing any official responsibilities, so as to direct business to any person, maintain an established business opportunity with any person, divert any business opportunity from any person or influence the enactment or promulgation of legislation or regulations of that government or instrumentality.

Prohibition against certain payments to officials by other domestic concerns

Section 104 of the bill would prohibit persons included in the definition of the term "domestic concern" who would not be covered by new section 30A of the Act from engaging in any of the same types of conduct prohibited by that section.

The term "domestic concern" is defined in the bill to mean an individual who is a citizen or national of the United States as well as any corporation, partnership, association, joint-stock company, business trust, or unincorporated organization which is owned or controlled by individuals who are citizens or nationals of the United States and which has its principal place of business in the United States or any territory, possession, or commonwealth of the United States.

The term "interstate commerce" is defined to mean trade, commerce, transportation, or communication among the several States, or between any foreign country and any State or between any State and [*page 18*] any place or ship on trade thereof. The term includes the interstate use of a telephone or other interstate means of communication and the intrastate use of any other interstate instrumentality.

The penalties for each violation of section 103 or section 104 would be a fine of up to $10,000 or imprisonment for up to 5 years, or both, but in the case of a corporation a fine of up to $500,000 could be imposed.

b. title ii - disclosure

[*OMITTED*]

Cost of Legislation

[*OMITTED*]

Additional Views of Senators Tower, Garn, and Lugar

[*OMITTED*]

1. See Senate Report No. 94-1031, 94th Cong., 2d sess.

2. See Senate Report No. 94-917, 94th Cong., 2d sess. (1976) to accompany S. 3084, the Export Administration Amendments, Foreign Boycotts, and Domestic and Foreign Investments Improved Disclosure Acts of 1976.

3. The phrase "disposition of its assets" is not intended as a limitation on the scope of the requirement that accurate books and records be maintained. The issuer's responsibility to keep records correctly reflecting the status of its liabilities and equities is no less than its obligation to maintain such records concerning its assets. The word "transactions" in the bill encompasses accuracy in accounts of every character.

4. For example, rule 2(e) of the Commission's rules of practice, 17 CFR 201.2(e), authorizes the Commission to censure, suspend, or bar professionals, such as accountants and lawyers, from practicing before the Commission. A public or private rule 2(e) proceeding might, in the Commission's view, be preferable, or used in addition to a civil injunctive action or criminal referral , in particular cases.

APPENDIX 10

Release No. 15570 (S.E.C. Release No.), Release No. 34-15570, 16 S.E.C. Docket 1143, 1979 WL 173674

Securities and Exchange Commission (S.E.C.)
Securities Exchange Act of 1934

SECURITIES AND EXCHANGE COMMISSION (S.E.C.)

Promotion of the Reliability of Financial Information and Prevention of the Concealment of Questionable or Illegal Corporate Payments and Practices

February 15, 1979

***1** AGENCY: Securities and Exchange Commission.

ACTION: Final rules.

SUMMARY: the Commission is adopting rules intended to assure that an issuer's books and records accurately and fairly reflect its transactions and dispositions of assets; to protect the integrity of the independent audit of issuer financial statements that is required under the Securities Exchange Act of 1934 ("Securities Exchange Act") and existing Commission rules; to promote the reliability and completeness of financial information that issuers are required to file with the Commission, or disseminate to investors, pursuant to the Securities Exchange Act; to promote compliance with new Sections 13(b)(2)(A) and (B) of the Securities Exchange Act; and to prevent the concealment of questionable or illegal corporate payments and practices. The rules expressly prohibit the falsification of corporate books, records, or accounts and prohibit the officers and directors of an issuer from making false, misleading or incomplete statements to any accountant in connection with any audit or examination of the issuer's financial statements or the preparation of required reports. Although the Commission's authority to promulgate rules of this nature does not rest solely on Section 13 of the Securities Exchange Act, these rules have been codified in a new Regulation 13B-2, entitled "Maintenance of Records and Preparation of Required Reports."

The Commission believes that these rules, while intended to deal with a much broader range of practices than the problem of questionable or illegal corporate payments and practices, will serve to discourage repetition of the serious abuses which the Commission has uncovered in this area. The Commission's experience indicates that improper corporate payments and practices are rarely reflected in corporate books, records and accounts in an accurate manner and that the desire to conceal information concerning such activities frequently entails the falsification of books, records and accounts and the making of false, misleading or incomplete statements to accountants.

EFFECTIVE DATE: March 23, 1979.

FOR FURTHER INFORMATION CONTACT: Barbara Leventhal, Division of Corporation Finance (202-755-1750); Frederick B. Wade, Office of the General Counsel (202-755-1229); Ernest Ten Eyck, Office of the Chief Accountant (202-755-7471); Securities and Exchange Commission, 500 North Capitol Street, Washington, D.C. 20549.

SUPPLEMENTARY INFORMATION: The SEC today announced the adoption of two rules under the Securities Exchange Act, 15 U.S.C. 78a et seq., as amended by the Foreign Corrupt Practices Act ("FCPA"), Pub. L. No. 95-213 (Dec. 19, 1977). The rules are codified in a new Regulation 13B-2, entitled "Maintenance of Records and Preparation of Required Reports." New Rule 13b2-1 (17 CFR 240.13b2-1) provides that "no person shall, directly or indirectly, falsify or cause to be falsified, any book, record or account subject to Section 13(b)(2)(A) of the Securities Exchange Act." [1] In addition, new Rule 13b2-2 (17 CFR 240.13b2-2) prohibits officers and directors of an issuer from making materially

false, misleading or incomplete statements to an accountant in connection with any audit or examination of the financial statements of the issuer or the filing of required reports. [2]

***2** The rules were initially published for comment in Securities Exchange Act Release No. 13185 (Jan. 19, 1977), together with a proposed amendment to Item 6 of Schedule 14A (17 CFR 240.14a-101). [3] The rules are designed to promote the reliability and completeness of the financial information that issuers are required to file with the Commission, or disseminate to investors, pursuant to the Securities Exchange Act; to protect the integrity of the independent audit of issuers' financial statements required under that Act and existing Commission rules; to promote compliance with new Sections 13(b)(2)(A) and (B) of the Securities Exchange Act; and to prevent the concealment of questionable or illegal payments and practices. In this regard, although the rules are intended, in part, to eliminate certain serious abuses the Commission has uncovered in connection with questionable and illegal payments and practices, the rules are addressed to a much broader range of practices than the problem of questionable or illegal corporate payments and practices.

I. Background

Beginning in 1973, as a result of the work of the Office of the Watergate Special Prosecuter, the Commission became aware of the pattern of conduct involving the use of corporate funds for illegal domestic political contributions. Because these activities often involved matters of significance to public investors, the nondisclosure of which entailed violations of the federal securities laws, the Commission published a statement, on March 8, 1974, expressing the views of its Division of Corporation Finance concerning disclosure of these matters in documents filed with the Commission. Securities Act Release No. 5466 (March 8, 1974).

Subsequent Commission investigations and enforcement actions revealed that instances of undisclosed questionable or illegal corporate payments—both domestic and foreign—were widespread, that they represented a serious breach in the system of corporate disclosure administered by the Commission and that such payments threatened public confidence in the integrity of the system of capital formation, which rests on a foundation of full and fair disclosure of corporate business and financial transactions. On May 12, 1976, the Commission submitted a detailed “Report on Questionable and Illegal Corporate Payments and Practices” (“May 12 Report”) to the Senate Committee on Banking, Housing and Urban Affairs. That report describes and analyzes the Commission's activities concerning such payments and practices and outlines the legislative and other responses that the Commission, based on its experience, recommended to remedy these problems. One of the key conclusions drawn in the May 12 Report was that:

> 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. Millions of dollars of funds have been inaccurately recorded in corporate books and records to facilitate the making of questionable payments. Such falsification of records has been known to corporate employees and often to top management, but often has been concealed from outside auditors and counsel and outside directors. [4]

***3** On the basis of the conclusions in the May 12 Report, the Commission, in addition to active pursuit of its enforcement and disclosure programs, proposed a multi-faceted approach to prevent further abuses. First, the Commission recommended that Congress enact legislation aimed expressly at enhancing the accuracy of corporate books

and records and the reliability of the audit process, which together constitute foundations of the system of corporate disclosure. Specifically, the Commission proposed legislation to:

(1) require issuers subject to the periodic reporting requirements of the Securities Exchange Act (i.e., “reporting companies”) to make and keep accurate books and records;

(2) require such issuers to devise and maintain a system of internal accounting controls meeting the objectives articulated by the American Institute of Certified Public Accountants in Statement on Auditing Standards No. 1. Section 320.28 (1973);

(3) prohibit the falsification of corporate accounting records; and

(4) prohibit the making of false, misleading or incomplete statements to an accountant in connection with any examination or audit.
In addition, because of the magnitude of the problem, and the need to supplement the Commission's own enforcement capabilities, a voluntary disclosure program was developed. Companies participating in this program were encouraged to conduct careful investigations of their operations under the auspices of persons not involved in the questionable activities and to discuss the question of appropriate disclosure of these matters with the Commission's staff before filing any document with the Commission. [5]

The Commission also proposed means of strengthening the effectiveness and vitality of corporate boards of directors by suggesting that issuers maintain audit committees composed of non-management directors unrelated to the company and its management and by encouraging the separation of the functions of independent corporate counsel and director. In the May 12 Report, the Commission proposed that, at least initially, these principles could best be implemented by an amendment to the listing requirements of the New York Stock Exchange and the rules of the other self-regulatory organizations, rather than by direct Commission action. [6]

II. Enactment of the Foreign Corrupt Practices Act of 1977

The Commission's legislative proposals were considered by the 94th Congress, but Congress adjourned before taking final action on the legislation. Following adjournment of the 94th Congress, the Commission, on January 19, 1977, published proposed rules for public comment in language substantially identical to the legislative proposals it had submitted to the Congress in the May 12 Report. [7]

The Commission's legislative proposals were given additional consideration by the 95th Congress. Two of the four proposals, the legislative analogs to proposed rules 13b-1 and 13b-2, were eventually incorporated in the FCPA in language virtually identical to that proposed by the Commission. The FCPA was signed by the President on December 19, 1977, and became effective on that date. [8]

***4** The primary impetus for enactment of the FCPA arose from disclosures of widespread corporate bribery. As the House Report concerning the legislation declared:
More than 400 corporations have admitted making questionable or illegal payments. The companies, most of them voluntarily, have reported paying out well in excess of $300 million in corporate funds to foreign government officials, politicians, and political parties. These corporations have included some of the largest and most widely held public companies in the United States; over 117 of them rank in the top Fortune 500 industries. The abuses disclosed run the gamut from bribery of high foreign officials in order to secure some type of favorable action by a foreign government to so-called facilitating payments that allegedly were made to ensure that government functionaries discharged certain ministerial or clerical duties. [9]

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The legislative history makes clear that Congress viewed such questionable or illegal payments as: (a) unethical and reprehensible; (b) inconsistent with the principles of a free market economy; (c) unnecessary to the successful conduct of business; and (d) a source of serious difficulties with respect to conduct of the nation's foreign policy. [10] In this regard, the FCPA creates a new Section 30A of the Securities Exchange Act, which makes it unlawful for any reporting company, or any officer, director, employee, or agent of such company, or any shareholder acting on behalf of such company, to make use of the mails or any means or instrumentality of interstate commerce, corruptly, in furtherance of an offer, payment, or gift, of any money or thing of value, to certain classes of persons. [11] The new provision applies to payments made for the purpose of influencing any act or decision of a foreign official, foreign political party or candidate for foreign political office (including a decision not to act), or inducing such a person or party to use his or its influence to affect any government act or decision in order to assist an issuer in obtaining, retaining or directing business to any person. [12]

New Section 13(b)(2) of the Securities Exchange Act incorporates two of the four legislative proposals that the Commission made in the May 12 Report. In this regard, the new provision requires every issuer that has a class of securities registered pursuant to Section 12 of the Securities Exchange Act, and every issuer that is required to file reports pursuant to Section 15(d) of the Securities Exchange Act (i.e., "reporting companies"):
(1) to make and keep books, and records and accounts which, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the issuer; and

(2) to devise and maintain a system of internal accounting controls sufficient to provide reasonable assurances that:
(i) transactions are executed in accordance with management's general or specific authorization;

(ii) transactions are recorded as necessary: (a) to permit preparation of financial statements in conformity with generally accepted accounting principles or other applicable criteria; and (b) to maintain accountability for assets;

***5** (iii) access to assets is permitted only in accordance with management's general or specific authorization; and

(iv) the recorded accountability for assets is compared with existing assets at reasonable intervals and appropriate action is taken with respect to any differences.

The Senate Report concerning the legislation indicates that the "accounting standards * * * [provisions] are intended to operate in tandem with the criminalization provisions of the bill to deter corporate bribery." [13] In this regard, the Report states that the accounting provisions are intended "to strengthen the accuracy of the corporate books and records and the reliability of the audit process which constitute the foundations of our system of corporate disclosure." [14] It also declares that "the affirmative duties" contained in the accounting provisions "will go a long way to prevent the use of corporate assets for corrupt purposes * * * [and that] public confidence in securities markets will be enhanced by assurance that corporate recordkeeping is honest." [15]

As noted above, the May 12 Report also proposed that Congress prohibit the falsification of corporate books, records and accounts and the making of false, misleading or incomplete statements to an accountant in connection with any examination or audit. The Senate bill contained such provisions, but limited the applicability of the provisions to violative conduct that was performed "knowingly." [16] The House bill "contained no comparable provisions because the SEC had already published for comment [the instant] rules designed to accomplish similar objectives under its existing authority." [17]

In the Conference Committee, the Senate receded to the House. [18] Although the conferees agreed that the two proposals "were supportive of the basic accounting section" enacted into law as part of the FCPA, [19] they determined to delete the provisions from the proposed legislation because use of the word "knowingly" in the Senate bill had become "involved in an issue never intended to be raised or resolved by the Senate bill—namely whether or not the inclusion or deletion of the word 'knowingly' would or would not affirm, expand, or overrule the decision of the Supreme Court in Ernst & Ernst v. Hochfelder (425 U.S. 185)." [20] In deleting the provisions, the conferees stated that they had decided not to "debate * * * the important issues raised by the Hochfelder decision" and that "no inference should be drawn [on the basis of the deletions] with respect to any rulemaking authority the SEC may or may not have under the securities laws." [21]

IV. Basis for Adoption of Regulation 13B-2

Section 23(a) of the Securities Exchange Act provides, in pertinent part, that the Commission shall "have power to make such rules and regulations as may be necessary or appropriate to implement the provisions of * * *" the Act. In this regard, the enactment of new Section 13(b)(2) provides a basis for promulgation of the new rules in addition to the various provisions cited in the release requesting comments concerning the rule proposals. [22]

***6** It bears emphasis that the accounting provisions of the FCPA are not exclusively concerned with the preparation of financial statements. An equally important objective of the new law, as well as pre-existing provisions of the federal securities laws cited in Securities Exchange Act Release No. 13185, supra, is the goal of corporate accountability.

In this context, new section 13(b)(2)(A) embodies certain requirements of integrity in corporate record-keeping. Thus, it requires issuers "to make and keep books, records, accounts, which, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the issuer." This provision is designed, not only to provide a more reliable basis for the preparation of financial statements, but also, among other things, for the purpose of confirming the Commission's authority "effectively to prevent off-the-books slush funds" [23] and to assure that "there is proper accounting of the use of corporate funds * * *" [24]

In addition, new Section 13(b)(2)(B) requires issuers to "devise and maintain a system of internal accounting controls sufficient to provide reasonable assurances that * * *" certain statutory objectives are met. These objectives include not only the recording of transactions "as necessary * * * to permit preparation of financial statements in accordance with generally accepted accounting principles * * *" or other applicable criteria, but also the recording of such transaction "as necessary * * * to maintain accountability for assets." In addition, these objectives expressly include the goals of providing reasonable assurances that access to corporate assets is permitted, and that corporate assets transactions are executed, "in accordance with management's general or specific authorization."

Accordingly, new Section 13(b)(2) establishes requirements concerning the internal activities of reporting companies that are supportive of the disclosure system mandated by the Securities Exchange Act, but should not be analyzed solely from that point of view. The new requirements may provide an independent basis for enforcement action by the Commission, whether or not violation of the provisions may lead, in a particular case, to the dissemination of materially false or misleading information to investors. [25]

As is set forth in more detail below, the rules promulgated today are intended to discourage the kind of abuses that led to enactment of the FCPA, and to promote compliance with new Section 13(b)(2) of the Securities Exchange Act. Accordingly, the Commission has determined that the rules are "necessary or appropriate," within the meaning of the Commission's general rulemaking authority, to implement new Section 13(b)(2).

Although the rules adopted today will be codified with rules promulgated under Section 13 of the Securities Exchange Act, the Commission is not relying exclusively on Section 13 as a foundation for the rules. As the Commission noted, in publishing the instant rule proposals for public comment:

> ***7** the close relationship between the[disclosure] objectives which Congress, in 1934, sought to accomplish by enactment of the Securities Exchange Act and the substance of its legislative proposals places those proposals within the reach of the Commission's general rulemaking authority under Section 23(a) of the Securities Exchange Act. [26]

In this context, the rules adopted today are also based, in part, upon a number of disclosure-related provisions, including: (a) Sections 13(a), 13(b)(1) and 15(d) of the Act, which set forth certain periodic reporting requirements; (b) Section 10(b), which prohibits fraud; (c) Section 14(a), which governs proxy solicitations; (d) Section 20(b), which prohibits unlawful conduct performed by any persons "through or by means of any other person"; and (e) Section 20(c), which prohibits any director or officer of, or any owner of securities issued by, any issuer required to file any document, report or information under * * *" the Securities Exchange Act without just cause to hinder, delay or obstruct the making or filing of any such document, report or information * * *." These provisions are sometimes referred to collectively in the remainder of this release as "the disclosure provisions" in order to distinguish them from new Section 13(b)(2) of the Securities Exchange Act. [27]

The Commission has determined, on the basis of the findings set forth in the May 12 Report and its experience in various enforcement actions involving questionable or illegal payments, [28] the legislative history of the FCPA [29] and careful consideration of the comments received concerning the rule proposals, that false corporate books and records and the making of false, misleading and incomplete statements to auditors often lead to a variety of activities that the Commission is authorized to curtail through exercise of its rulemaking authority to implement the "disclosure provisions." These activities include, but are not limited to:
(1) the utilization of deceptive devices, such as materially false statements or material omissions, in connection with the purchase or sale of securities in interstate commerce:

(2) the filing of inaccurate and incomplete periodic reports with the Commission and the dissemination of such reports to investors;

(3) the solicitation of proxies in contravention of the proxy rules, including Rule 14a-9, 17 CFR 240.14a-9; and

(4) the hindrance, delay, and obstruction of the making and filing of required documents, reports and information.

Accordingly, the Commission has determined that the rules adopted today are "necessary or appropriate," within the meaning of Section 23(a) of the Securities Exchange Act, to implement the foregoing "disclosure provisions" and that such rules are "necessary or appropriate" in the public interest, for the protection of investors and to insure fair dealing in securities.

A. Adoption of Rule 13b2-1 (Proposed Rule 13b-3)

***8** Proposed Rule 13b-3 would have prohibited any person from falsifying corporate books and records maintained pursuant to proposed Rule 13b-1. As adopted, Rule 13b2-1 has been modified to reflect the enactment of new Section

13(b)(2)(A) of the Securities Exchange Act, the Commission's concomitant decision not to adopt proposed rule 13b-1 and certain technical or clarifying changes in the language of the rule. Thus, the new rule provides that "no person shall, directly or indirectly, falsify or cause to be falsified, any book, record or account subject to Section 13(b)(2)(A) of the Securities Exchange Act."

The Commission has determined that Rule 13b2-1, while not directed solely to the problem of questionable or illegal corporate payments and practices, should serve to discourage a repetition of the serious abuses the Commission has uncovered. The Commission's experience, as set forth in the May 12 Report and subsequent enforcement actions, [30] demonstrates that questionable or illegal payments are rarely reflected correctly in corporate books and records and that the need to suppress information concerning such payments has frequently entailed the falsification of corporate books, records or accounts.

New Section 13(b)(2)(A) of the Securities Exchange Act requires that corporate books and records "accurately and fairly reflect the transactions and dispositions of the assets of the issuer." This provision is intended, among other things, to preclude the maintenance of off-the-books slush funds and to insure that corporate transactions and dispositions are properly recorded. It bears emphasis, in this context, that the new requirement is qualified by the phrase "in reasonable detail" rather than by the concept of "materiality."

In the Commission's judgment, new Rule 13b2-1 should promote compliance with the statutory requirement that issuers have accurate books and records by discouraging persons from falsifying any corporate book, record, or account subject to new Section 13(b)(2)(A) and by making individuals directly liable for such conduct. Accordingly, the Rule is "necessary or appropriate," within the meaning of the Commission's general rulemaking authority, to implement new Section 13(b)(2) of the Securities Act.

In addition, the maintenance of accurate books and records by reporting companies is one of the foundations of the system of corporate disclosure embodied in the Securities Exchange Act. In this regard, the disclosure requirements of the Securities Exchange Act are based on the premise that "No investor * * * can safely buy or sell securities * * * without having an intelligent basis for forming his judgment as to the value of the securities he buys or sells." [31]

As the Commission has previously indicated, "The maintenance of accurate books and records by publicly-held companies is a necessary concomitant of the existing requirement for full, fair and accurate periodic reports." [32] In addition, as the May 12 Report reflects, the Commission's experience is that the falsification of corporate books and records has often been associated with the making of questionable and illegal payments. [33] In certain cases, concealed corporate payments and off-the-books slush funds were the result of actions by particular individuals, who acted with or without the knowledge of corporate management, to cause such transactions to be improperly recorded. [34] Given the importance of adequate information to "the maintenance of fair and honest [securities] markets," [35] the sensitivity of securities prices to the availability of material information, and the close nexus between the maintenance of accurate books and records and the ability of reporting companies to disclose such information, the Commission has determined that the new rule is "necessary or appropriate" to implement "the disclosure provisions," and that, in this context, the rule is also "necessary or appropriate" in the public interest, for the protection of investors and to insure fair dealing in securities.

***9** The Commission received comments from approximately 70 persons with respect to proposed Rule 13b-3, most of which expressed opposition to aspects of the rule. Many comments advocated changes that would: (a) limit application of the rule to "material" falsifications of corporate books, records and accounts; (b) require a showing of "scienter" before a person could be held liable for violations of the rule; and (c) limit application of the rule to persons having certain affiliations with an issuer, rather than "any person".

The advocates of a “materiality” standard expressed concern that false entries of insignificant or nominal amounts would give rise to a violation of the rule. In addition, some comments asserted that, in view of the large number of books, records and accounts kept by some corporations, particularly large corporations, application of the rule to any falsification of such books, records and accounts would make compliance impossible.

The Commission has considered these concerns and determined that it would not be desirable to modify the rule as suggested. New Rule 13b2-1 is, as noted above, applicable to “any book, record or account subject to Section 13(b)(2)(A) of the Securities Exchange Act.” That provision was qualified by the Conference Committee, prior to enactment of the FCPA, to make clear that issuers are required 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 * * *.” [36] The Report of the Conference Committee indicates the change was made because the provision, “if unqualified, might connote a degree of exactitude and precision which is unrealistic.” [37] It adds, “The amendment makes clear that the issuer's records should reflect transactions in conformity with accepted methods of recording economic events and effectively prevent off-the-books slush funds and payments of bribes.” [38]

The Commission believes the presence of the words “in reasonable detail” in Section 13(b)(2)(A) should alleviate much of the concern expressed in comments concerning proposed rule 13b-3. In addition, it bears emphasis that compliance with new Section 13(b)(2)(B) of the Securities Exchange Act, concerning systems of internal accounting control, and increased use of audit committees composed of persons unaffiliated with the corporation or its management should facilitate compliance with new Rule 13b2-1. A further consideration is the Commission's concern that a limitation concerning “material” falsity would unduly narrow the scope of the rule and result in an unwarranted diminution of investor protection. Under these circumstances, the Commission has determined that it would be inappropriate to limit application of the Rule in the manner suggested.

Many comments expressed the view that a showing of “scienter” ought to be required in order to establish violations of the Rule. These comments were premised on the views that some false entries in corporate books, records and accounts result from inadvertent errors or oversights, and that a number of such entries are inevitable, particularly in view of the volume of transactions that must be recorded on a daily basis by large public companies. Some comments added that it would be unfair to impose liability upon persons who acted in good faith and made inadvertent or unintentional mistakes.

***10** After careful consideration of the comments, the Commission has determined that a “scienter” requirement should not be included in the Rule. The inclusion of such a requirement would be inconsistent with the language of new section 13(b)(2)(A), which contains no words indicating that the Congress intended to impose a “scienter” requirement. It would be anomalous, under these circumstances, to include a “scienter” requirement in the new Rule.

Moreover, the Commission believes that the concern expressed with respect to inadvertent and inconsequential errors is unwarranted. The statute does not require perfection but only that books, records and accounts “in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the issuer” (emphasis added). In addition, the legislative history reflects that “standards of reasonableness” are to be used in applying this provision. [39]

Although Section 13 of the Securities Exchange Act authorizes the Commission to impose certain requirements upon issuers, Rule 13b2-1 provides that “no person” shall violate the terms of the Rule. The Rule, as proposed, contained substantially similar language applicable to “any person.” In this regard, a number of commentators suggested that the rule should be applicable only to certain persons affiliated with an issuer rather than to “any person.”

The Commission has considered these comments, but has determined to promulgate the rule in a form substantially the same as that proposed. The effect of falsifications of books, records ar accounts, in making reports required under Section 13 misleading or incomplete, is not necessarily contingent on the identity of the wrongdoer or on whether he

acts with the knowledge or acquiescence of management. Moreover, while normally only officers and employees of the issuer are in a position to falsify corporate records, it is not feasible to identify in the Rule all categories of persons who might violate it. Consequently, the Commission believes that the rule should apply to any person who, in fact, does cause corporate books and records to be falsified.

Accordingly, because the falsification of accounting records, especially if falsified in order to conceal questionable corporate practices, may lead, among other things, to the concealment of material information that should be disclosed in periodic reports or to purchasers and sellers of the issuer's securities and to the omission of such information from proxy solicitations, and may also hinder the preparation of required reports, the Commission believes that the extension of Rule 13b2-1 to any person who violates the prohibition is “necessary or appropriate” to implement the “disclosure provisions” set forth as a basis for promulgation of the rule. [40]

B. Adoption of Rule 13b2-2 (Proposed Rule 13b-4).

Rule 13b2-2 prohibits any officer [41] or director of an issuer, directly or indirectly, from making any materially false or misleading statement, or omitting to state any material fact necessary to make statements made not misleading, to an accountant in connection with an audit of the financial statements of the issuer or the filing of required reports. The Rule is similar to proposed rule 13b-4, although certain technical or clarifying changes have been made and the Rule has been narrowed by the deletion of “security holders” from the class of persons subject to the Rule. [42]

***11** Based on its review of cases involving questionable or illegal corporate payments, the Commission's May 12 Report concluded:

> The almost universal characteristic of the cases * * * has been the apparent frustration of our system of corporate accountability which has been designed to assure that there is proper accounting for the use of corporate funds and that documents filed with the Commission and circulated to shareholders do not omit or misrepresent material facts. [43]

In this context the new Rule is primarily intended to help restore the efficacy of the system of corporate accountability and to encourage boards of directors to exercise their authority to deal with the problem. [44]

The Commission intends that the new rule encompass the audit of financial statements by independent accountants, the preparation of any required reports, whether by independent or internal accountants, the preparation of special reports to be filed with the Commission, as, for example, those filed pursuant to judicial orders incident to Commission enforcement proceedings, and any other work performed by an accountant that culminates in the filing of a document with the Commission.

As noted above, new Rule 13b2-2 is being promulgated, in part, pursuant to Section 13(b)(2) of the Securities Exchange Act. In this regard, the Commission has determined that the adoption of the Rule will promote compliance with the requirement of new Section 13(b)(2)(B) that issuers devise and maintain a system of internal accounting controls sufficient to achieve certain statutory objectives by assisting auditors in evaluating an issuer's system of internal accounting controls in connection with an examination or audit of the issuer's financial statements or the preparation or filing of any document or report with the Commission. Although the auditor's evaluation of the system of internal accounting control is traditionally conducted principally for the purpose of assisting the auditor in determining the scope and nature of his examination, such evaluations also frequently result in weaknesses in internal accounting

controls being brought to the attention of the issuer by the auditor. The authoritative auditing literature (Statement on Auditing Standards No. 20) requires that defined "material weaknesses" which came to the attention of the auditor be communicated to the issuer.

Similarly, new Section 13(b)(2)(A) requires reporting companies to "make and keep books, records, and accounts which in reasonable detail, accurately and fairly reflect the transactions and disposition of the assets of the issuer." The Commission believes that the adoption of new Rule 13b2-2 will act as a deterrent to the falsification of corporate books, records and accounts and to the making of false, misleading or incomplete statements to an accountant or auditor that might conceal the falsification of such books and records. Accordingly, the Commission has determined that adoption of Rule 13b2-2 is "necessary or appropriate," within the meaning of Section 23(a), to implement the provisions of new Section 13(b)(2).

***12** The prohibition against making false, misleading or incomplete statements to accountants, in connection with an audit, or the filing of required reports, is also being promulgated as "necessary or appropriate" to implement the various "disclosure provisions," discussed above in connection with Rule 13b2-1, and as "necessary or appropriate" in the public interest, for the protection of investors and to insure fair dealing in securities. In this regard, the accountant's examination or audit of the financial statements of the issuer is a crucial element in safeguarding the reliability of the information that is disclosed to the public pursuant to the disclosure requirements of the Securities Exchange Act. The integrity of the financial disclosure system is diminished when issuers impede accountants or auditors in the discharge of their responsibilities by providing them with false, misleading or incomplete information.

In this context, the Commission believes that new Rule 13b2-2 will encourage careful and accurate communications between auditors and issuers from whom they request information during the audit process, deter the making of false, misleading or incomplete statements to accountants, and thereby enhance the integrity of financial disclosure system.

The Commission received comments from approximately 80 persons with respect to proposed Rule 13b-4, most of which questioned certain aspects of the proposal. The majority of these comments expressed concern that the proposed rule would: (a) require no showing of scienter in order to establish a violation based upon the making of false, misleading or incomplete statements to an accountant in the course of an examination or audit; (b) impose liability for oral, as well as written, statements made to an accountant; and (c) make minority shareholders of an issuer liable for violations of the rule. In addition, many of the comments asserted that imposition of liability for mistatements or omissions, in the absence of a scienter requirement, would be counter-productive and impede communications between auditors and those from whom they seek information in the course of an audit. In fact, a number of comments suggested that some persons would refuse to communicate with an auditor rather than expose themselves to potential liability.

The Commission disagrees with the assertion that a scienter requirement should be added to the Rule for the reasons set forth above at pp. 24-25 with respect to Rule 13b2-1.[45] In addition, the Commission believes its experience concerning questionable and illegal payments is more persuasive as to the need for such a rule than the opinions expressed by some commentators to the effect that the rule will impede communications between auditors and those from whom they seek information. Under these circumstances, the Commission has decided that the advantages of the new Rule outweigh the potential disadvantages suggested by certain commentators.

Some of the comments suggested that the proposed rule should be applicable only to written statements that are submitted to an auditor in the course of an examination or audit and that oral statements should not be covered by the rule. In this regard, it was suggested that auditors will usually obtain written representations concerning matters of material significance and that such a limitation would permit persons to review written communications and thereby minimize the possibility that false, misleading or incomplete statements would be made in the absence of scienter or an intent to deceive.

***13** The Commission believes that a distinction between written and oral statements is inappropriate, primarily because oral statements may be no less harmful to investors than a misleading written statement. Moreover, section 12(2) of the Securities Act,[46] and the antifraud provisions of the Securities Exchange Act, have long been applied in Commission enforcement actions and private actions to oral mistatements without unusual or unintended consequences. While the Commission is sensitive to concerns expressed by some commentators that oral statements which are inaccurately recorded in accountants' work papers may become the basis for liability under the Rule, on balance, the Commission believes a distinction between written and oral statements would unduly narrow the scope of the Rule. Moreover, this concern can be alleviated to some degree by the exercise of care in the preparation of accountants' work papers and by accountants' requesting written confirmations of material representations.

New Rule 13b2-2, as adopted, is applicable only to any director or officer of an issuer. In this regard, most of the comments concerning the proposed rule questioned the applicability of the rule to any owner of securities issued by a reporting company. Several suggested that the rule should be applicable only to controlling shareholders, or the beneficial owners of a certain percentage of a class of securities, while others expressed the view that the rule, as drafted, would discriminate between employees of an issuer who own the issuer's securities and those employees who do not. In addition, some comments opined that shareholders might be deterred from providing confirmations to accountants if they were made subject to the rule. After careful consideration of these comments, the Commission decided to delete shareholders from the coverage of the new Rule.

It must be stressed, however, that the exclusion from the express language of the new Rule of shareholders, low-level corporate employees of an issuer, and persons unaffiliated with the issuer does not indicate that those individuals may mislead the issuer's accountants with impunity. As noted above, controlling persons of an issuer may be held liable for such conduct by virtue of Section 20 of the Securities Exchange Act.[47] In addition, the existing antifraud provisions of the federal securities laws, and the concept of aiding and abetting, can be invoked, in appropriate circumstances, against those who deceive the auditors of a publicly held corporation. In this area, as in other areas where duties and liabilities are created under the federal securities laws, case-by-case balancing is essential with respect to the needs of the investing public and the interests of those who have engaged in conduct injurious to investors.

V. Other Matters

The Commission specifically requested comments concerning "the likely impact, if any, which * * * [the proposed rules] would have on competition.[48] Approximately ten comments addressed this issue, but the comments were primarily directed toward proposed rules 13b-1 and 13b-2, which would have imposed requirements upon reporting companies. The Commission has determined that the instant rules will not impose a "burden on competition" within the meaning of Section 23(a)(2) of the Securities Exchange Act.

***14** The Commission has also considered whether it might be appropriate to republish these rules for further public comment. In this regard, the Commission decided that it is not necessary to obtain additional comments before promulgating the new rules and that the delay inherent in republication would not be in the public interest. The Commission intends, however, to monitor the impact of the new rules and invites comments from interested persons concerning that subject.

VI. Text of Rules

Accordingly, 17 CFR 240 is amended by adding §§240.13b2-1 and 240.13b2-2 as set forth below:

REGULATION 13B-2: MAINTENANCE OF RECORDS AND PREPARATION OF REQUIRED REPORTS

§240.13b2-1 Falsification of accounting records.

No person shall, directly or indirectly, falsify or cause to be falsified, any book, record or account subject to Section 13(b)(2)(A) of the Securities Exchange Act.

§240.13b2-2 Issuer's representations in connection with the preparation of required reports and documents.

No director or officer of an issuer shall, directly or indirectly,
(a) make or cause to be made a materially false or misleading statement, or

(b) omit to state, or cause another person to omit to state, any material fact necessary in order to make statements made, in the light of the circumstances under which such statements were made, not misleading to an accountant in connection with (1) any audit or examination of the financial statements of the issuer required to be made pursuant to this subpart or (2) the preparation or filing of any document or report required to be filed with the Commission pursuant to this subpart or otherwise.

By the Commission (Chairman Williams and Commissioners Loomis, Evans, and Pollack concurring; Commissioner Karmel dissenting)
George A. Fitzsimmons
Secretary

February 15, 1979

Separate Statement of Views By Commissioner Karmel:

The Foreign Corrupt Practices Act of 1977 was enacted after the comment period had closed with respect to the proposals for these rules. Therefore, I believe it would have been desirable as a matter of policy to republish the proposals and seek additional comments concerning the relationship between the proposed rules and the accounting provisions of the new statute.

With respect to the substance of the new rules, I would have preferred a more restrained implementation of the Commission's statutory authority. In my view, the Commission should have limited the applicability of Rule 13b2-1, as a matter of policy, to cases of intentional falsification of accounting records, or deliberate circumvention of internal accounting control systems. Although, in my view, “falsify” implies an element of deceit, it does not go far enough in articulating a standard of wrongful intent for culpable conduct. In addition, I do not believe it is necessary or appropriate to regulate communications between accountants and their clients by way of the prohibitions contained in Rule 13b2-2.

***15** For the foregoing reasons, I disagree with the Commission's determination to promulgate new Regulation 13B-2 as drafted at this time.

Footnotes

1 Section 13(b)(2)(A) of the Securities Exchange Act was added to the Act by the FCPA. It requires issuers subject to the Act 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.”
Section 3(a)(37) of the Securities Exchange Act defines the term “records” to mean “accounts, correspondence, memorandums, tapes, discs, papers, books and other documents or transcribed information of any type, whether expressed in ordinary or machine language.”

2 As proposed, Rules 13b2-1 and 13b2-2 were designated 13b-3 and 13b-4, respectively. See Securities Exchange Act Release No. 13185 (Jan. 19, 1977), 42 FR 4854 (Jan. 26, 1977). The rules promulgated today have been renumbered to reflect the intervening enactment of the FCPA, which incorporated the substance of proposed rules 13b-1 and 13b-2 in new Section 13(b)(2) of the Securities Exchange Act, and the Commission's determination that enactment of the FCPA makes it unnecessary to adopt proposed Rules 13b-1 and 13b-2.

3 As proposed, a new subsection (d) would be added to Item 6 of Schedule 14A, requiring disclosure of management involvement in specified types of questionable or illegal payments and practices and of corporate policies relating to such matters. The Commission expects to consider this proposal in the near future.

4 May 12 Report at p.a.

5 The voluntary program was announced in several public statements, including the testimony of Commissioner Philip A. Loomis on July 17, 1975, before the Subcommittee on International Economic Policy of the House Committee on International Relations and the testimony of former Commission Chairman Roderick M. Hills before the Subcommittee on Priorities and Economy in Government on January 14, 1976. See May 12 Report, supra, at pp. 7-8. Since the program was announced, more than 450 companies have disclosed information relating to questionable or illegal activities in filings with the Commission.

6 See letter from former Chairman Roderick M. Hills to William Batten, Chairman, New York Stock Exchange (NYSE), dated May 11, 1976 (May 12 Report, Exhibit D). The NYSE subsequently adopted a requirement that listed companies have an audit committee which meets certain specified criteria by June 30, 1978. Similar rules have been considered by other national exchanges and the NASD.

7 See Securities Exchange Act Release No. 13185, supra, (Jan. 19, 1977).

8 As noted, supra, p. 3, the FCPA is contained in Title I of Pub. Law No. 95-213.

9 H.R. Rep. No. 95-640, 95th Cong., 1st Sess. 4 (1977).

10 Id. at 4-5; S. Rep. No. 114, 95th Cong., 1st Sess. 3-4 (1977).

11 These classes include an official of a foreign government; a foreign political party or an official thereof; a candidate for foreign political office; or any other person where the reporting company knows, or has reason to know, that all or a portion of such money or thing of value will be offered, given or promised, directly or indirectly, to one of the foregoing persons.

A "foreign official" is defined by Section 30A to mean "any officer or employee of a foreign governmetn or any department, agency or instrumentality thereof, or any person acting in an official capacity for or on behalf of such government or department, agency, or instrumentality." The term does not include employees "whose duties are essentially ministerial or clerical."

12 Violations of new Section 30A may result in the imposition of a fine of "not more than $1,000,000" upon any issuer convicted of a violation and, withr respect to individuals, in the imposition of a fine of not more than $10,000, or imprisonment for not more than 5 years, or both.

The FCPA also subjects any domestic business concern, other than one subject to the reporting requirements of the Securities Exchange Act, and any officer, director or agent of such a domestic business concern, or any natural person in control of such a domestic concern, to the same prohibitions and penalties that are applicable to reporting companies. That portion of the FCPA is administered and enforced, however, by the Department of Justice rather than the Commission.

13 S. Rep. No. 114, supra, at 7.

14 Id.

15 Id. The Report of the Conference Committee concerning the FCPA makes clear that the requirement that corporate books and records be "accurate" is intended "to prevent off-the-books slush funds and payments of bribes" without regard to whether such funds or payments are material in amount. H.R. Rep. No. 95-831, 95th Cong., 1st Sess. 10 (1977).

16 S. Rep. No. 114, supra, at 9. In this regard, the Senate Report declared that the latter proposal "is designed to encourage careful communications between auditors and persons from whom the auditors seek information in the audit process. The Committee is of the view that a proscription on knowing false statements to auditors will enhance the integrity of the audit process" (Id.).

17 See H.R. Rep. No. 95-831, supra, at 10.

18 Id.

19 Id.

20 Id. at 10-11. In Hochfelder, the Supreme Court held that a plaintiff in an implied private action for damages under Section 10(b) of the Securities Exchange Act, 15 U.S.C. 78j(b), and Rule 10b-5 promulgated thereunder, 17 CFR 240.10b-5, must allege and prove that the defendant acted with scienter, i.e. "a mental state embracing intent to deceive, manipulative or

defraud" (see 425 U.S. at 193-194, n.12). The Court specifically left open "the question whether scienter is a necessary element in an action for injunctive relief under Section 10(b) and Rule 10b-5" (Id.).

21 H.R. Rep. No. 95-831, supra, at 11.

22 See Securities Exchange Act Release No. 34-13185, supra.

23 See H.R. Rep. No. 95-831, supra, at 10.

24 (Emphasis added). See May 12 Report at a.

25 For example, although new Section 13(b)(2) imposes requirements upon issuers that are designed, in part, to promote the reliability and completeness of financial information and to protect the integrity of the independent audit of an issuer's financial statements, these new statutory requirements are qualified by the terms "in reasonable detail" and "reasonable assurances," as distinguished from the concept of materiality.

26 See Securities Exchange Act Release No. 34-13185, supra.

27 In this context, of course, Sections 20(b) and 20(c) are "disclosure provisions" only insofar as they may be applicable in tandem with one or more of the other provisions noted above.

28 See e.g., the May 12 Report, Exhibit B; Securities and Exchange Commission v. Aminex Resources Corp., et al. (D.D.C., Civil Action No. 78-0410) Securities and Exchange Commission v. Page Airways, Inc. (D.D.C., Civil Action No. 78-0656) Securities and Exchange Commission v. Katy Industries, (N.D. Ill., No. C 78-3476).

29 See S. Rep. No. 114, supra; H.R. Rep. No. 95-640, supra; and H.R. Rep. No. 95-831, supra.

30 See, e.g., n. 28, supra.

31 H. Rep. No. 1383 73rd Cong., 2nd Sess. 11 (1934); see S. Rep. No. 1455, 73rd Cong., 2nd Sess. 68 (1934).

32 See Securities Exchange Act Release No. 14478 (Feb. 16, 1978).

33 May 12 Report at a.

34 Id.

35 See Section 2 of the Securities Exchange Act, 15 U.S.C. 78b.

36 H.R. Rep. No. 98-831, supra at 10 (emphasis added).

37 Id.

38 Id.

39 S. Rep. 95-114, supra, at 8.

40 In this regard, Section 10(b) of the Act authorizes the Commission to prohibit manipulative or deceptive devices—regardless of by whom employed—in connection with the purchase or sale of securities. Section 14(a) of the Act, as implemented by Rule 14a-9, 17 CFR 240.14a-9, prohibits "any person" from soliciting proxies by means of proxy materials that contain false or misleading statements. In addition, Section 20(c) of the Act prohibits "any director or officer of, or any owner of any securities issued by, any issuer required to file any document, report or other information" from hindering, delaying or obstructing the making or filing of such document, report or information.

41 Securities Exchange Act Rule 3b-3, 17 CFR 240.3b-3, defines the term "officer" to mean "a president, vice-president, treasurer, comptroller, and any other person who performs for an issuer, whether incorporated or unincorporated, functions corresponding to those performed by the foregoing officers."

42 It bears emphasis, however, that controlling persons of any issuer may be liable for violations of the new Rule by virtue of Section 20(a) of the Securities Exchange Act. In addition, insofar as any director or officer of, or any owner of securities issued by, any issuer, engages in conduct prohibited by the new Rule in order to hinder, delay or obstruct the making or filing of any required report, document or information, such persons may be liable by virtue of Section 20(c) of the Act.

43 May 12 Report at a.

44 See May 12 Report at b.

45 See pp. 24-25, supra.

46 15 U.S.C. 77l(2).

47 See n. 42, supra.

48 See Securities Exchange Act Release No. 34-13185, supra.

Release No. 15570 (S.E.C. Release No.), Release No. 34-15570, 16 S.E.C. Docket 1143, 1979 WL 173674

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APPENDIX 11

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ARTICLES

THE ACCOUNTING PROVISIONS OF THE FOREIGN CORRUPT PRACTICES ACT—THE FEDERALIZATION OF CORPORATE RECORDKEEPING AND INTERNAL CONTROL

Daniel L. Goelzer*

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* Executive Assistant to Harold M. Williams, Chairman, Securities and Exchange Commission. This article was originally prepared in partial satisfaction of the requirements of the L.L.M. Degree at the National Law Center, George Washington University. A copy of the manuscript is on file in the library of the National Law Center. The Securities and Exchange Commission, as a matter of policy, disclaims responsibility for any private publication by any of its employees. The views expressed herein are those of the author and do not necessarily reflect the views of the Securities and Exchange Commission or of the author's colleagues upon the staff of the Commission. *See* 17 C.F.R. § 200.735-4(f) (1978).

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I. INTRODUCTION

On December 19, 1977, President Carter signed into law the Foreign Corrupt Practices Act of 1977.[1] The Act is the culmination of almost three years of congressional interest in the problem of illegal or improper payments emanating from American corporations doing business overseas.[2] The Senate Committee in which the legislation originated described the Act as "a strong anti-bribery law" and recommended its passage to the Senate based on the need "to bring these corrupt prctices to a halt and to restore

1. Foreign Corrupt Practices Act of 1977, Pub. L. No. 95-213, § 104, 91 Stat. 1494. The legislation passed the Senate and House as S. 305 on, respectively, Dec. 6 and 7, 1977.

2. One compilation has identifed 22 separate pieces of legislation and 7 congressional resolutions introduced during the second session of the 94th Congress in order to deal with the problem of corporate bribery in the course of the foreign business of U.S. firms. *See* Ferrara & Goelzer, *Saints and Sinners Concluded: The Foreign Corrupt Practices Act*, in Corporate Conduct Overseas: The U.S. Criminal Laws and International Codes at 99 (PLI 1978).

public confidence in the integrity of the American business system."[3] Similarly, President Carter characterized the bill as the fulfillment of a campaign promise "for tough legislation to prohibit corporate bribery."[4]

As these statements suggest, much of the congressional and public interest in the Act has focused on the provisions[5] which prohibit American businesses from making interest payments to officials of foreign governments.[6] This is hardly surprising in light of both the publicity which has surrounded disclosures of improper payments[7] and the severe criminal sanctions for such payments. Fines of $1 million may be imposed against corporations registered under the Securities Exchange Act of 1934 or other domestic concerns; 5-year prison terms or fines of up to $10,000 may be imposed against any officer, director, shareholder, employee, or agent acting on behalf of such an issuer or concern.[8] Indeed, the severity of the antibribery penalties may make American multinationals unable or unwilling to compete in world trade and compliance with antibribery provisions may embarrass U.S. foreign relations.[9]

A. Substantive Provisions

The new Act has two major provisions. First, the Act narrowly defines certain categories of corrupt payments and requires issuers subject to the registration and reporting provisions of the Securities Exchange Act of 1934 to "make and keep books, records, and accounts, which, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the

3. REPORT OF THE SENATE COMM. ON BANKING, HOUSING AND URBAN AFFAIRS TO ACCOMPANY S. 305 [hereinafter cited as *Senate Report on S. 305*]. S. REP. No. 114, 95th Cong., 1st Sess. 4 (1977). *Reprinted in* [1977] U.S. CODE CONG. & AD. NEWS 4098, 4101.

4. 13 WEEKLY COMP. OF PRES. DOC. 1909 (Dec. 21, 1977).

5. As to companies required to file reports under the Securities Exchange Act of 1934, these prohibitions are contained in § 103 of the Foreign Corrupt Practices Act of 1977, enacting a new § 30A of the Securities Exchange Act, 15 U.S.C. 78dd (1976 & Supp. I 1977). As to "other domestic concerns," parallel prohibitions are enacted by § 104 of the Foreign Corrupt Practices Act of 1977, 15 U.S.C. 78dd-1 (1976 & Supp. I 1977).

6. *See, e.g.*, Sprow & Benedict, *The Foreign Corrupt Practices Act of 1977: Some Practical Problems and Suggested Procedures*, 1 CORP. L. REV. 357 (1978); Estey & Marston, *Pitfalls (and Loopholes) in the Foreign Bribery Law*, FORTUNE, Oct. 9, 1978, at 182; Best, *The Foreign Corrupt Practices Act*, 11 REV. SEC. REG. 975 (1978); Jensen, *Antibribery Law Has Some Teeth*, New York Times, Dec. 25, 1977, at 2E.

7. *See generally* N. Jacoby, P. Nehemkis, R. Eells, BRIBERY AND EXTORTION IN WORLD BUSINESS (1977). An exhaustive analysis of the types of disclosures made, based on an examination of the public filings of 109 corporations, appears in T. Kennedy & C. Simon, AN EXAMINATION OF QUESTIONABLE PAYMENTS AND PRACTICES (1978); *see also* Report of the Securities and Exchange Commission on Questionable and Illegal Corporate Payments and Practices Submitted to the Committee on Banking, Housing and Urban Affairs, United States Senate (May 12, 1976), *reprinted in*, [1976] 353 SEC. REG. & L. REP. (BNA) 1 [hereinafter cited as *May 12 Report*].

8. As to issuers of securities registered under the Securities Exchange Act of 1934, the penalty provisions applicable to violations of the new antibribery law are set forth in amended § 32(c) of that Act, 15 U.S.C. § 78ff(c) (1976 & Supp. I 1977). As to "other domestic concerns," the penalties are set forth in § 104 of the Foreign Corrupt Practices Act, 15 U.S.C. § 78dd-2 (1976 & Supp. I 1977). Agents and employees are only exposed to criminal liability where the employer or principal has already been convicted. 15 U.S.C. §§ 78dd-2(b)(3), 78ff(c)(3) (1976 & Supp. I 1977).

9. In this vein, President Carter's September 26, 1978 statement concerning U.S. export policy directs the Justice Department to "provide guidance to the business community concerning its enforcement priorities" in implementing the antibribery provisions of the Act. 14 WEEKLY COMP. OF PRES. DOC. 1631, 1633 (Oct. 2, 1978).

assets of the issuer."[10] Secondly, the Act requires issuers to "devise and maintain a system of internal accounting controls sufficient to provide reasonable assurances" that four specified objectives are attained.[11] These "accounting provisions," which are distinct from the antibribery prohibition, have been characterized as "the most extensive application of federal law to internal corporate affairs since the passage of the 1933 and 1934 Acts."[12]

The legislative history indicates that Congress viewed new section 13(b)(2) as a measure to foster managerial accountability and corporate integrity by eliminating the weaknesses in corporate financial control and recordkeeping which permitted corrupt payments. Indeed, the Securities and Exchange Commission argued that the "most devastating disclosure that we have uncovered . . . has been the fact that, and extent to which, some companies have falsified entries in their own books and records."[13] The SEC accordingly recommended legislation to bring the integrity of corporate recordkeeping within the ambit of the federal securities laws.[14] Thus, despite their common ancestry, the accounting provisions are much broader than the antibribery sections of the new Act. The section 13(b)(2) accounting provisions encompass the day-to-day operation of the recordkeeping and internal accounting control systems of all publicly-held American issuers.[15]

B. *Impact of the Accounting Provisions*

The accounting provisions may affect the governance and accountability mechanisms of most major corporations, the work of their independent auditors, and the role of the Securities and Exchange Commission. For public companies, the most immediate problem is evaluating whether current corporate internal accounting controls comply with the Act. Although the accounting profession and the organized bar have undertaken to afford some guidance in this area,[16] the task is a complex one.[17] Moreover, the Com-

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10. Securities Exchange Act of 1934, § 13(b)(2)(A) 15 U.S.C. § 78m(b)(2)(A), (1976 & Supp. 1977).

11. Securities Exchange Act of 1934, § 13(b)(2)(B), 15 U.S.C. § 78m(b)(2)(B) (1976 & Supp. I 1977).

12. *Accounting Provisions of the Foreign Corrupt Practices Act Discussed at New York Law Journal Seminar*, [1978] 451 SEC. REG. & L. REP. (BNA) D-1, D-1, *quoting* Alan B. Levenson, formerly Director of the Commission's Division of Corporation Finance; *see also* Kohn, *Severe Effect Upon Business Seen in New Securities Law*, N.Y.L.J., April 26, 1978, at 1, col. 2-3.

13. *May 12 Report*, *supra* note 7, at 58, [1976] 353 SEC. REG. & L. REP. (BNA) at 13.

14. *See id.* at 57-59, 63-66, [1976] 353 SEC. REG. & L. REP. (BNA) at 13-15,

15. *See* American Bar Association Committee on Corporate Law and Accounting, *A Guide to the New Section 13(b)(2) Accounting Requirements of the Securities Exchange Act of 1934*, 34 BUS. LAW. 307, 308 (1978) [hereinafter cited as *ABA Guide*] (". . . [F]oreign bribery is a relatively rare event, but maintenance of financial records and internal accounting controls are major every-day acitivities of every registered or reporting company.") In that vein, one commentator has argued that the accounting provisions may give the Commission the power to regulate the manner in which issuers "account for virtually every specific element of cost and what documentation must exist to legitimize a cost," Rishe, *"Sleeper" Provision Gets SEC Foot Into Corporate Accounting Doors*, Legal Times of Washington, Sept. 4, 1978, at 15.

16. *See* American Institute of Certified Public Accountants, *Tentative Report of the Special Advisory Committee on Internal Accounting Control* (Sept. 15, 1978) [hereinafter cited as *AICPA Tentative Report*]; *ABA Guide.*

17. *See* McCoy & Griffin, *Illegal Payments Abroad: Congress' Response*, Legal Times of Washington, Oct. 30, 1978, at 8, 9-10.

sions, congressional scrutiny of questionable payments began much earlier. Fact-gathering hearings were held in 1975[45] and early 1976.[46] As the Commission's voluntary disclosure and management fraud enforcement programs gathered momentum, congressional interest intensified. More than thirty bills were eventually introduced, including a wide variety of proposed solutions to the corrupt payments problem.[47] One of the central themes which ran throughout the congressional debates was the concept that the weaknesses of corporate recordkeeping and control systems were abuses which required remedial legislative action. This theme was reflected in the Commission's management fraud enforcement and voluntary disclosure programs and set forth in the Commission's May 12 Report.

The nexus between the abuses described to Congress by the Commission and the accounting provisions which resulted from Congress's review of that information is central to an understanding of the new statute. Congress's objective was not merely to promote the process by which financial statements are prepared, but also to increase the integrity of corporate recordkeeping in order to foster management integrity. During floor debate before the enactment of the Foreign Corrupt Practices Act, Senator Harrison Williams, one of the bill's sponsors, summarized the philosophy which supporters of the accounting provisions saw as the basis for the legislation:

> In addition to the direct prohibition of foreign corrupt payments, the bill also imposes an affirmative requirement on publicly owned American corporations to strengthen the accuracy of corporate books and records and the reliability of the audit process. These are the bedrock elements of our system of corporate disclosure and accountability. . . .
>
> The accounting sections of the bill, of course, reach beyond the problem of bribery and other questionable payments. . . . [They] will prevent defiance or circumvention of the system of corporate accountability, assure reliable and accurate books and records, protect the integrity of the audit process and make clear the responsibilities of corporate management and accountants, and safeguard fundamental precepts of corporate democracy.[48]

1. *Deliberations in the Second Session of the 94th Congress*

a. *Legislative proposals*

In the 94th Congress, consideration of legislation to strengthen corporate accounting practices focused chiefly on three bills, S. 3133, S. 3379, and S. 3418. Each of these proposals reflected the principle articulated in the May 12 Report that accurate recordkeeping is an essential ingredient in promoting management responsibility.

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45. *See Hearings on the Activities of American Multinational Corporations*, *supra* note 38.

46. *See Abuses of Corporate Power: Hearings Before the Subcomm. on Priorities and Economy in Government of the Joint Econ. Comm.*, 94th Cong., 1st & 2d Sess. 3-4 (1976) (statement of Roderick M. Hills).

47. *See* Ferrara & Goelzer, *supra* note 2.

48. 123 CONG. REC. S19,400 (daily ed. Dec. 6, 1977).

APPENDIX 12

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THE POTENT AND BROAD-RANGING IMPLICATIONS OF THE ACCOUNTING AND RECORD-KEEPING PROVISIONS OF THE FOREIGN CORRUPT PRACTICES ACT

STUART H. DEMING*

The criminal law of every country makes the corruption of its public officials a criminal offense.[1] Yet, until the latter part of the 20th century, almost every country limited the prohibitions to its own officials and not officials of other countries or international organizations.[2] This was in spite

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* Stuart H. Deming practices with DEMING PLLC in its offices in Washington, D.C. and Kalamazoo, Michigan. He previously served with the Securities and Exchange Commission ("SEC") and in various capacities with the U.S. Department of Justice. Mr. Deming is the author of *The Foreign Corrupt Practices Act and the New International Norms* recently published by the American Bar Association ("ABA") and a member of the board of editorial advisors to Business Laws, Inc. (FCPA). For many years, he co-chaired the ABA's National Institutes on the Foreign Corrupt Practices Act and was a founder and a co-chair of the ABA's Task Force on International Standards for Corrupt Practices. Mr. Deming received his B.A., M.B.A., and J.D. from the University of Michigan. He has also been licensed as a Certified Public Accountant in the State of Michigan.

[1] *See* Jefferi Joan Hamilton, Note, *Foreign Corrupt Practices Act of 1977: A Solution or a Problem?*, 11 CAL. W. INT'L L.J. 111, 134 (1981).

[2] That situation has dramatically changed in recent years with the adoption and implementation of a series of international anti-bribery conventions by much of the developed world and increasingly by much of the developing world. Following the adoption of the Foreign Corrupt Practices Act in 1977, the United States was for many years the only country to prohibit improper payments to foreign officials. The adoption in 1997 by the Organization of Economic Co-operation and Development of the Convention on Combating Bribery of Foreign Officials in International Business Transactions ("OECD Anti-Bribery Convention") led to the implementation by most of the developed world of prohibitions on improper payments to foreign officials. Nov. 21, 1997, OECD DOC. DAFFE/IME/BR(97)20, *reprinted in* Argentina-Brazil-Bulgaria-Chile-Slovak Republic-Organization for Economic Cooperation and Development: Convention on Combating Bribery of Foreign Public Officials in International Business Transactions, Dec. 18, 1997, 37 I.L.M. 1. Much of the rest of the world either has or is in the process of implementing similar prohibitions through the implementation of the Organization of American States' Inter-American Convention Against Corruption, Mar. 29, 1996, OAS DOC. B-58, *reprinted in* Organization of American States: Inter-American Convention Against Corruption, Mar. 29, 1996, 35 I.L.M. 724, which was adopted in 1996. *See also* Council of Europe Criminal

of general, if often unstated, agreement that the proliferation of this form of corruption threatens the functioning of democratic institutions and market economies.[3]

In 1977, as an outgrowth of the Watergate scandal and a series of revelations associated with that period,[4] Congress adopted the Foreign Corrupt Practices Act ("FCPA") to deter improper payments to foreign officials.[5] Yet, in reality, the FCPA's provisions play a far greater role in legal jurisprudence in the United States and elsewhere than is generally recognized. Aside from directly affecting business practices of individuals and entities in international settings, on a daily basis the FCPA bears directly on the foreign and domestic operations of publicly-held companies and many foreign companies entering U.S. capital markets. Often, in unexpected ways, it is increasingly having an impact on litigation and arbitral proceedings.[6]

Law Convention on Corruption ("CoE Criminal Law Convention"), ETS No. 173 27.1.1999, which was adopted in 1998; and the United Nations Convention Against Corruption ("UN Convention"), G.A. Res. 58/4, U.N. GAOR, 58th Sess., U.N. Doc. A/RES/58/4 (2003), *reprinted in* United Nations Convention Against Corruption, Dec. 11, 2003, 43 I.L.M. 37 (2004), which was adopted in 2003. All of these anti-bribery conventions have now entered into force.

[3] STUART H. DEMING, THE FOREIGN CORRUPT PRACTICES ACT AND THE NEW INTERNATIONAL NORMS 1 (2005).

[4] "Beginning in 1973, as a result of the work of the Office of the Watergate Special Prosecutor, the [Securities and Exchange] Commission became aware of a pattern of conduct involving the use of corporate funds for illegal domestic political contributions." Promotion of Reliability of Financial Information, Exchange Act Release No. 34-15570, [1979 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 81,959, at 81,960 (Feb. 15, 1979) [hereinafter Exchange Act].

> Subsequent Commission investigations revealed that instances of undisclosed questionable or illegal corporate payments—both domestic and foreign—were indeed widespread and represented a serious breach in both the operation of the Commission's system of corporate disclosure and, correspondingly, in public confidence in the integrity of the system of capital formation.

Id. More than 400 corporations admitted making questionable payments. H.R. REP. NO. 95-640, at 4 (1977), *reprinted in* 2 BUSINESS LAWS, INC. (FCPA) 342. "The abuses disclosed run the gamut from bribery of high foreign officials . . . to secure some type of favorable action by a foreign government to so-called facilitating payments . . . to ensure that government functionaries discharged certain ministrial [sic] or clerical duties." *Id.*

[5] 15 U.S.C. §§ 78m, 78dd-1, 78dd-2, 78dd-3, 78ff (2000 & Supp. 2005).

[6] The FCPA can serve, for example, as a basis in certain situations for not enforcing a contract. In litigation in U.S. courts and in other common law jurisdictions, the "unclean hands" doctrine can bar a claim for equitable relief. DEMING, *supra* note 3, at 381. In some situations, the doctrine has also been applied to bar a cause of action where a payment may have been made in violation of the anti-bribery provisions. 15 U.S.C. §§ 78dd-1, 78dd-2, 78dd-3; *see, e.g.*, Adler v. Federal Republic of Nig., 219 F.3d 869, 876-78 (9th Cir. 2000); SEDCO Int'l, S.A. v. Cory, 683 F.2d 1201, 1210-11 (8th Cir. 1982).

I. THE FCPA'S TWO PRINCIPAL MECHANISMS

Initially designed to deter improper payments to foreign officials in connection with business activities, the FCPA instituted two basic mechanisms to carry out its purposes. One is a set of prohibitions on payments to foreign officials.[7] These are generally referred to as the "anti-bribery provisions." The anti-bribery provisions first come to mind when reference is made to the FCPA. They prohibit any promise, offer, or payment of anything of value if the offeror "knows" that any portion will be offered, given, or promised to a foreign official, foreign political party, or candidate for public office for the purpose of influencing a governmental decision.[8]

The second mechanism is comprised of a set of provisions known as the "accounting and record-keeping provisions."[9] Through the accounting and record-keeping provisions, the FCPA placed new and significant affirmative obligations on entities subject to its terms to maintain systems of internal controls and to maintain records that accurately reflect transactions and dispositions of assets.[10] These provisions directly affect business practices unrelated to the making of improper payments to foreign officials. In so doing, they directly affect the worldwide operations of entities subject to their terms and extend to their majority-owned subsidiaries and officers, directors, employees, shareholders, and agents acting on their behalf.[11]

In the context of international arbitration, arbitral tribunals and courts enforcing or annulling arbitral awards are increasingly confronted with situations where the enforcement of a contract or of an award relating to a contract may be barred due to improper payments in conjunction with the contract. DEMING, *supra* note 3, at 381. Over the years, arbitrators have asserted the existence of "an international public order which makes bribery contracts invalid and contrary to *bonos mores.*" A. Timothy Martin, *International Arbitration and Corruption: An Evolving Standard*, INT'L ENERGY & MIN. ARB., MIN. LAW SERIES (2002). Some tribunals have found national laws to also hold such contracts illegal.

Until the recent adoption of the anti-bribery conventions, *see supra* note 2 and accompanying text, no specific reference to international law could be made. DEMING, *supra* note 3, at 381. That has now changed. There can be little question that an agreement to pay a bribe is contrary to customary international law and not just a breach of moral standards. Arbitrators can accordingly be expected to be more and more confronted with arguments of this nature by parties challenging the enforcement of a contract where allegations of improper payments exist. *Id.*

[7] 15 U.S.C. §§ 78dd-1, 78dd-2, 78dd-3.

[8] *Id.*

[9] *Id.* §§ 78m(b)(2), 78m(b)(4)-(7), 78ff(a).

[10] Foreign Corrupt Practices Act of 1977, Pub. L. No. 95-213, § 102, 91 Stat. 1494.

[11] *See, e.g.*, DEMING, *supra* note 3, at 21; Arthur F. Matthews, *Defending SEC and DOJ FCPA Investigations and Conducting Related Corporate Internal Investigations: The Triton*

The two mechanisms are conceptually different from one another. The anti-bribery provisions are proscriptive whereas the accounting and record-keeping provisions are prescriptive in nature.[12] Their scope and application also differ. Each set of provisions must be considered separately, and neither provision should be considered alone.[13] They were intended to work in "tandem" and thereby complement one another.[14] A certain set of facts may suggest a violation of the anti-bribery provisions. At the same time, the same set of facts may not suggest a violation of the accounting and record-keeping provisions.

II. THE EXPANSIVE NATURE OF THE ACCOUNTING AND RECORD-KEEPING PROVISIONS

The FCPA's accounting and record-keeping provisions constitute the FCPA's second and less-known mechanism for deterring improper payments to foreign officials. While their application is ostensibly limited to issuers,[15] the accounting and record-keeping provisions constitute the far more potent mechanism. Unlike the anti-bribery provisions, they are not limited to the making of improper payments to foreign officials. The accounting and record-keeping provisions "have a much broader reach."[16] They apply to all aspects of the practices relating to the preparation of the financial statements of an entity subject to their terms.[17]

The accounting and record-keeping provisions go far beyond simply addressing the bribery of foreign officials. One of the problems disclosed by the revelations of the Watergate era in the United States was the accounting and record-keeping practices that made improper payments

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Energy/Indonesia SEC Consent Decree Settlements, 18 NW. J. INT'L L. & BUS. 303, 349 (1998) (citing 2 KATHLEEN F. BRICKEY, CORPORATE CRIMINAL LIABILITY § 9:20, at 279 (1992)).

[12] DEMING, *supra* note 3, at 6.

[13] *Id.*

[14] S. REP. NO. 95-114, at 3, 7 (1977), *reprinted in* 1977 U.S.C.C.A.N. 4098. For example, the Senate report associated with the FCPA's passage stated that "a U.S. company 'which looks the other way' in order to be able to raise the defense that they were ignorant of bribes made by a foreign subsidiary, could be in violation of [the accounting and record-keeping provisions] requiring companies to devise and maintain adequate accounting controls." *Id.* at 11.

[15] *See infra* text accompanying notes 39-47, for discussion of what constitutes an issuer for purposes of the accounting and record-keeping provisions.

[16] THOMAS LEE HAZEN, 2 LAW OF SECURITIES REGULATION 348 (5th ed. 2005).

[17] See *infra* Section V, for discussion as to the scope of the record-keeping provisions, especially as they may relate to records not directly related to the preparation of financial statements.

possible.[18] To address these practices, the accounting and record-keeping provisions placed new and significant obligations on the worldwide operations of all entities subject to its terms to maintain records that accurately reflect transactions and dispositions of assets and to maintain systems of internal accounting controls.[19]

"Congress believed that almost all such bribery was covered up in the corporation's books, and that to require proper accounting methods and internal accounting controls would discourage corporations from engaging in illegal payments. Congress recognized that both investors and the corporation itself would benefit from accurate bookkeeping."[20]

> Although one of the major substantive provisions of the FCPA is to require corporate disclosure of assets as a deterrent to foreign bribes, the more significant addition of the FCPA is the accounting controls or "books and records" provision, which gives the SEC authority over the entire financial management and reporting requirements of publicly-held United States corporations.[21]

Congress recognized at the time of the FCPA's consideration that the accounting provisions would have an effect extending beyond "questionable payments" made in connection with foreign business.[22] The SEC report proposing the legislation concerning accounting and record-keeping practices, which was in large part ultimately adopted as part of the FCPA,[23] stated that questionable payments "cast doubt on the integrity and

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[18] *See supra* note 4. One of the "key conclusions" drawn from the SEC investigations during that period was that

> [t]he 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. Millions of dollars of funds have been inaccurately recorded in corporate books to facilitate the making of questionable payments. Such falsification of records has been known to corporate employees and often to top management, but often has been concealed from outside auditors and counsel and outside directors.

Promotion of Reliability of Financial Information, *supra* note 4 (citing Report of the Securities and Exchange Commission on Questionable and Illegal Corporate Payments and Practices, *submitted to* S. Comm. on Banking, Hous. and Urban Affairs 3 (May 12, 1976) [hereinafter Questionable Payments Report]).

[19] *See* DEMING, *supra* note 3, at 21; Matthews, *supra* note 11, at 349.

[20] Lewis v. Sporck, 612 F. Supp. 1316, 1333 (N.D. Cal. 1985) (citing S. REP. NO. 95-114).

[21] Sec. & Exch. Comm'n v. World-Wide Coin Inv., Ltd., 567 F. Supp. 724, 746 (N.D. Ga. 1983).

[22] GARY LYNCH, ENFORCEMENT OF THE ACCOUNTING PROVISIONS OF THE FOREIGN CORRUPT PRACTICES ACT OF 1977, at I (1983), *reprinted in* 2 BUSINESS LAWS, INC. 260.001.

[23] Questionable Payments Report, *supra* note 18, at 63-69. The proposed language for a new § 78m(b)(2) was identical to what later became § 78m(b)(2) under § 102 of the FCPA.

reliability of the corporate books and records which are the very foundation for the disclosure system established by the federal securities laws."[24] The report went on to state that "[i]mplicit 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 systems administered by the SEC."[25]

Critics of the accounting provisions recognized that the effect of the SEC's proposal would apply to more than foreign payments.[26] A representative of the American Institute of Certified Public Accountants testified that the SEC proposal

> goes far beyond the problem of illegal corporate payments in establishing a required corporate structure of corporate accountability and by making it illegal to distort proper recordkeeping. The proposed amendment would, for the first time, involve the SEC on a broad basis in corporate activities which do not involve filings with the Commission or transactions in securities.[27]

Despite these concerns, "Congress interjected itself into this process by establishing accounting standards for regulated companies and requiring them to implement a system of accounting controls to insure that the accounting standards are met."[28] The adoption of the accounting and record-keeping provisions "reflect[ed] a congressional determination that the scope of the federal securities laws and the SEC's authority should be expanded beyond the traditional ambit of disclosure requirements."[29]

That congressional determination as to the expansive nature of the accounting and record-keeping provisions has not waned over time. At the core of the heightened obligations under the Sarbanes-Oxley Act of 2002

Foreign Corrupt Practices Act of 1977, Pub. L. No. 95-213, § 102, 91 Stat. 1494. While the proposed language for new §§ 78m(b)(3) and § 78m(b)(4) were not included in § 102, *id.*, both provisions, with one modification, later became Rules 13b2-1 and 13b2-2; *see* Promotion of Reliability of Financial Information, *supra* note 4. Unlike the proposed § 78m(b)(4), Questionable Payments Report, *supra* note 18, at 64, the modification restricted the application of Rule 13b2-2 to officers and directors. Exchange Act Release No. 13,185 [1976-1977 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 80,896, at 87,382 (Jan. 19, 1977). Indeed, the SEC proposed what later became Rules 13b2-1 and 13b2-1 nearly a year before the adoption of the FCPA. *See id.*; *cf. infra* note 103.

[24] Questionable Payments Report, *supra* note 18, at 3.

[25] *Id.*

[26] LYNCH, *supra* note 22, at 2.

[27] *Foreign Payments Disclosure*: *Hearings on H.R. 13481, S. 3664, H.R. 13870 and H.R. 13953 Before the Subcomm. on Consumer Prot. and Fin. of the H. Comm. on Interstate and Foreign Commerce*, 94th Cong. 18 (1976).

[28] Lewis v. Sporck, 612 F. Supp. 1316, 1329 (N.D. Cal. 1985).

[29] Sec. & Exch. Comm'n v. World-Wide Coin Inv., Ltd., 567 F. Supp. 724, 747 (N.D. Ga. 1983).

preparation of financial statements."[111] It noted that "[a]n equally important objective . . . [was] the goal of corporate accountability."[112]

Commentators are in accord that, at the very least, the record-keeping provisions apply to records that are relevant to the preparation of financial statements.[113] However, there is case law that states that "Congress' use of the term 'records' suggests that virtually any tangible embodiment of information made or kept by an issuer is within the scope of section 13(b)(2)(A) of the FCPA, such as tape recordings, computer print-outs, and similar representations."[114]

No categorical statement can be made as to what records are beyond the purview of the record-keeping provisions. The particular circumstances will ultimately dictate what records are subject to their terms.[115] But in general, the greater the degree to which a record may relate to the preparation of financial statements, the adequacy of internal controls, or the performance of audits,[116] the more courts are likely to find the record to be

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[111] Promotion of Reliability of Financial Information, *supra* note 4.

[112] *Id.*

[113] *See* Exchange Act Release No. 15,570, [1979 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 81,959 (Feb. 15, 1979); STEPHEN F. BLACK & ROGER M. WITTEN, COMPLYING WITH THE FOREIGN CORRUPT PRACTICES ACT § 6.03[1], at 6-7; *ABA Symposium, Practical Implications of the Accounting Provisions of the Foreign Corrupt Practices Act of 1977, and Recent Developments: A Program by Committee on Corporate Law and Accounting*, 35 BUS. LAW. 1713, 1726-30 (1980) (comments of Edward D. Herlihy, Assistant Dir., Sec. & Exch. Comm'n. Div. of Enforcement); Mary Jane Dundas & Barbara George, *Historical Analysis of the Accounting Standards of the Foreign Corrupt Practices Act*, 10 MEM. ST. U. L. REV. 499 (1980); Mary Jane Dundas & Barbara George, *Responsibilities of Domestic Corporate Management Under the Foreign Corrupt Practices Act*, 31 SYRACUSE L. REV. 865 (1980); Matthews, *supra* note 11, at 353 (citing *Guide*, *supra* note 102, at 313); Siedel, *Internal Accounting Controls Under the Foreign Corrupt Practices Act: A Federal Law of Corporations?*, 18 AM. BUS. L.J. 444, 459-65 (1981).

[114] *World-Wide Coin Inv., Ltd.*, 567 F. Supp. at 748-49.

[115] As an example, without some relationship to the preparation of financial statement, records relating to the maintenance of equipment are less likely to fall within the scope of the record-keeping provisions. However, that assessment could dramatically change if the maintenance costs were significant or if the nature of the maintenance being performed was essential to ensuring the reliability of equipment vital to the operation of a business. *Cf. id.* at 749 ("As a practical matter, the standard of accuracy in records will vary with the nature of the transaction involved.").

[116] *Cf.* S. REP. NO. 95-114, at 7 (1977), *reprinted in* 1977 U.S.C.C.A.N. 4098 ("The purpose of the [accounting and record-keeping provisions is to strengthen the accuracy of the corporate books and records and the reliability of the audit process . . . ."). Given Sarbanes-Oxley's emphasis on internal controls and deterring conduct that might impede or affect the audit function, *see supra* Section II, by inference Congress has reaffirmed the broad scope of records subject to the terms of the accounting and record-keeping provisions.

subject to the terms of the record-keeping provisions.[117] Records such as corporate minutes, transactional documents, authorizations for expenditures are all incidental to the preparation of financial statements or recording economic events.[118] They also directly relate to internal controls and audits of financial statements.

Consistent with the statute's accounting and record-keeping provisions,[119] Rule 13b2-1 contains no materiality requirement.[120] Rule 13b2-1 provides "an independent basis for enforcement action . . ., whether or not violation of the provisions may lead, in a particular case, to the dissemination of materially false or misleading information to investors."[121] "Even if the amount of a payment would not affect the 'bottom line' of an issuer in quantitative terms, it could still constitute a violation of the record-keeping provisions if not accurately recorded. The record-keeping provisions apply to all payments, not merely sums that would be material in the traditional financial sense."[122]

This represents a dramatic departure from the traditional approach taken by U.S. securities laws. Historically, except for disclosures as to certain aspects of an issuer's activities,[123] materiality was the overriding consideration as to what required disclosure and what constituted a violation. But as a result of the record-keeping provisions, relatively insignificant amounts of money, if not properly recorded, can have serious ramifications.[124]

Similarly, the manner in which information is entered into an issuer's records can become very important under Rule 13b2-1. Manipulating an entity's books or records to mask transactions by characterizing them in some oblique way, or by actually falsifying a transaction, can lead to

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[117] BLACK & WITTEN, *supra* note 114, § 6.03[1] at 6-8.

[118] *Id.*

[119] 15 U.S.C. § 78m(b)(2)(A) (Supp. 2005).

[120] *World-Wide Coins Inv. Ltd.*, 567 F. Supp. at 749.

[121] Promotion of Reliability of Financial Information, *supra* note 4.

[122] DEMING, *supra* note 3, at 22.

[123] For example, until the adoption of the FCPA, one of the relatively few exceptions to the materiality requirement related to related-party transactions involving family members. Item 404(a) of Regulation S-K provides that any transaction worth over $60,000 involving a director or his immediate family must be disclosed. *See* 17 C.F.R. § 229.404(a) (2005).

[124] When a violation of the anti-bribery provisions may be involved, the SEC has "zero" tolerance when record-keeping violations are also involved. Gregary S. Bruch, Assistant Dir., Div. of Enforcement, Sec. & Exch. Comm'n, Remarks at the American Conference Institute's Ninth National Foreign Corrupt Practices Act Program (Dec. 3, 2001).

serious exposure for an issuer and those individuals involved.[125] For example, placing a transaction into an abnormal category or "burying" it in some other way could serve as a basis for an enforcement action for a violation of Rule 13b2-1.[126]

2. *Rule 13b2-2*

Rule 13b2-2 prohibits any officer or director from making materially false or misleading statements or failing to state any material facts in the preparation of filings required by the Exchange Act.[127] Officers and directors of an issuer, or anyone acting on their behalf, are prohibited from "taking any action to fraudulently influence, coerce, manipulate, or mislead any independent public or certified accountant engaged in the performance

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[125] While the provisions of Rule 13b2-1 have broad application to the books and records of an issuer, "enforcement officials have less tolerance for inaccurate records that may bear more directly on compliance obligations of an issuer." DEMING, *supra* note 3, at 23. The context in which a record may have been falsified, such as concealment of a violation of law or the true financial status of an issuer, will be critical factors in a determination as to whether enforcement action will be taken for a violation of Rule 13b2-1. DEMING, *supra* note 3, at 23; *cf. infra* notes 126, 144 and accompanying text.

[126] Facilitating payments provide a classic example of the interplay between the accounting and record-keeping provisions and the anti-bribery provisions. For example, facilitating payments, which are permitted under the anti-bribery provisions, 15 U.S.C. §§ 78dd-1(b), 78dd-2(b), 78dd-3(b) (2000 & Supp. 2005), could pose a problem if not accurately described. An effort to conceal facilitating payments by placing them among other types of payments would be improper. DEMING, *supra* note 3, at 23. It is the improper classification that would be false and which could serve as a basis for a violation.

If a facilitating payment represents a relatively small amount of money and has no relationship to any particular function of an entity, its inclusion in a category of miscellaneous items may not be inappropriate. *Id.* at 24. Its classification is not necessarily inaccurate or false. "Similarly, the degree to which the facilitating payments may be rolled up into larger line items and thereby hidden is not necessarily improper as long as the manner in which such payments are incorporated into a larger line item is logical and not for the purpose of concealing questionable transactions." *Id.* The classification is not necessarily false or inaccurate. It is mere circumstance that leads to the facilitating payment being, in effect, "buried." But should the payment be incorrectly classified so that it may be rolled up into a larger line item and thereby concealed, then there may be a basis to allege a violation of the record-keeping provisions. *Id.*

Considerations relative to adequate internal controls also relate to facilitating payments. *Id.* If the facilitating payments are not properly approved or recorded, an issuer opens itself up to possible allegations of inadequate internal controls. *Id.* Indeed, for an issuer extensively engaged in international business, the failure to have a compliance program may constitute a violation of the internal control provisions of the accounting and record-keeping provisions. *See infra* note 166.

[127] 17 C.F.R. § 240.13b2-2(b) (2005).

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