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Beware the SEC's Sweeping Definition of Books, Records

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The federal securities laws require public companies to make and keep detailed and accurate "books, records, and accounts." One might assume that a securities law relating to books and records covers materials used in the preparation of financial statements. But in practice, the U.S. Securities and Exchange Commission applies a much broader definition that seems to encompass every piece of paper and data in a company's possession.

Background of the Books and Records Provision

The books and records provision was enacted in 1977 as part of the Foreign Corrupt Practices Act (FCPA). It requires issuers—companies that are required to file reports with the SEC or that have securities registered with the SEC—to "make and keep books, records, and accounts, which, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the issuer."

In one of the few reported decisions discussing the books and records provision, a federal district court described the provision's three goals:

(1) assure that an issuer's books and records accurately and fairly reflect its transactions and the disposition of assets, (2) protect the integrity of the independent audit of issuer financial statements that are required under the Exchange Act, and (3) promote the reliability and completeness of financial information that issuers are required to file with the Commission or disseminate to investors pursuant to the Exchange Act. SEC v. World-Wide Coin Investments Ltd. (N.D. Ga. 1983)

That the books and records provision was enacted as part of the FCPA is deceiving; the provision covers practices that may be neither foreign nor corrupt. In recent years, the SEC has brought enforcement actions for books and records violations in circumstances that had nothing to do with bribery and related to purely domestic transactions—for example, records relating to the value of mortgage-backed securities; round-tripping transactions that led to overstated revenue; options backdating; and miscalculation of tax liabilities.

The SEC generally imposes strict liability for inaccurate or insufficiently detailed books and records because the statute does not explicitly require materiality or scienter. In other words, a company may be held liable for sloppy entries in its books and records, no matter how small, and regardless of whether there was any intent to deceive.

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What Constitutes an Issuer's Books and Records

In light of the strict liability associated with inaccurate books and records, exactly what company materials come within the scope of the books and records provision is a critical question. The statute itself does not provide an answer. Because the provision was added to Section 13 of the Securities Exchange Act of 1934, which addresses reports that must be filed with the SEC, it would be reasonable to assume that books and records are only materials that are relevant to an issuer's preparation of financial statements.

The legislative history of the provision supports this view. The Senate Report on the proposed legislation explained that the requirement of "honest . . . corporate recordkeeping" was to protect "the reliability of the audit process [and] the foundations of our system of corporate disclosure." At the time, the SEC made the same connection to financial reporting; in a report to Congress proposing the adoption of what would become the books and records provision, the SEC argued the provision was necessary because, "[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 system administered by the Commission."

But the SEC's recent enforcement efforts reveal a much broader view of the scope of the books and records provision. The SEC has alleged books and records violations relating to documents far removed from the financial reporting process, including third-party contracts, meeting minutes, invoices to customers, and bid proposals to potential customers. Some of these materials had no possibility of impacting the company's financial statements.

An enforcement action filed in May illustrates the point. In In the Matter of BHP Billiton Ltd, the SEC sued a company based on internal documents relating to the company's hosting of customers at the 2008 Summer Olympics. As part of its process for selecting and approving customers to host, the company created "hospitality applications"—purely internal forms that employees prepared in order to invite an individual to the Olympics. According to the SEC, some hospitality applications described certain employees of state-owned enterprises as "customer" rather than "representative of government." Other applications, the SEC charged, provided boilerplate, insufficiently detailed explanations of the company's past dealings with the potential guests. While there were no bribery charges, the SEC alleged violations of the books and records and internal controls provisions based on the descriptions in the hospitality applications. There is no discussion in the SEC's Order regarding how the hospitality applications may have impacted the company's accounts or financial statements. The case is noteworthy for its focus on purely internal documents unrelated to any alleged bribery or financial reporting problem, not to mention the $25 million penalty.

The few courts to address the books and records provision have not helped to narrow its scope. For example, the district court in World-Wide Coin described the books and records problems there in terms of their impact on the "audit trail with respect to these transactions and the disposition of World-Wide's assets." But the court adopted a more sweeping definition of books and records: "virtually any tangible embodiment of information made or kept by an issuer."

In another case, a former human resources officer was charged with books and records violations after she helped to create false committee meeting minutes relating to the dates stock options were awarded. United States v Jensen (N.D. Cal. 2008) The officer argued for a jury instruction requiring some nexus between the books and records at issue and the financial reporting process, but the court flatly rejected any such requirement.

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The Bottom Line

The message from the SEC, and endorsed by some courts, appears to be that issuers must worry about everything—emails, proposals, meeting minutes—not just the general ledger and accounting records. This broad definition of books and records imposes significant compliance burdens. Companies should be sure that, at the very least, compliance polices and employee training materials address the SEC's expansive view.