

EVOLUTION OF CORPORATE GOVERNANCE IN THE UNITED STATES OF AMERICA

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ABSTRACT

Corporate governance has become an important issue in the 1990's and especially after corporate accounting disasters worldwide. Stakeholders of companies, investors and regulatory bodies in particular, are insisting on implemetation of adequate corporate governance practices by the companies. The United States with the most developed securities market, has always been the pioneering country in making and applying regulations for corporate governance. Therefore, examining the evolution of corporate governance in the United States will be useful for understanding current practices.

Keywords: Corporate governance, U.S.Legislations, Intenational Conventions

ÖZET

Kurumsal yönetim, özellikle dünyadaki muhasebe skandallarından sonra 1990'lardan itibaren önem kazanmıştır. Şirketlerin çıkar grupları, yatırımcılar ve özellikle düzenleyici kurullar uygun kurumsal yönetim uygulamalarının şirketler tarafından uygulanması konusunda ısrar etmektedirler. En gelişmiş sermaye piyasalarının olduğu Amerika Birleşik Devletleri kurumsal yönetime ilişkin düzenlemeler yapılmasında ve uygulanmasında her zaman öncü ülke olmuştur. Bu nedenle, kurumsal yönetimin Birleşik Devletler'deki evrimini incelemek bugünkü uygulamaları anlamak açısından yararlı olacaktır.

Anahtar Kelimeler: Kurumsal Yönetim, ABD'deki Düzenlemeler, Uluslararası Konvansiyonlar

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1. Introduction

Corporate governance refers to control of corporations and to systems of accountability by those in control. It is about ensuring that executives and boards are accountable to shareholders while managing risks and enhancing competitiveness on a corporate and national level. The idea of corporate governance was originally developed in 1962 as a way of ensuring that investors receive a fair return on their investment by having a certain protection against management abuse or poor use of their investment capital (Arsalidou and Wang, 2005). There have been several critical events that occurred over the past two centuries that have mandated a drastic change in corporate governance. Not only did these acts establish best practices, but also enable major changes in accounting, auditing, shareholder investments, and business processes in general.

The motivation of this study is to present the milestones of corporate governance in the United States (U.S.), hence, these milestones; the stock market crash of 1929, which resulted in the Securities Act of 1933 and Securities Exchange Act of 1934, the Foreign Corrupt Practice Act of 1977 and the Sarbanes Oxley Act of 2002 will be explained in the study. Furthermore, important international conventions affecting the U.S. practice will also be mentioned in this context.

2. The Stock Market Crash of 1929 and its Consequences

The stock market crash of 1929 indicated the need for regulations promoting corporate governance practices and a regulatory body for securities markets.

2.1. The Stock Market Crash of 1929

The stock market crash of 1929, which occurred during the last week in October, was a series of days in which the stock market plummeted in a chain reaction, ruining many companies, banks, and investors. Its consequences affected American consumption, banking, and the economy in general (Erickson, 2007). The stock market crash, which had triggered the Great Depression, was the first event that catapulted a chain of events that influenced corporate governance in the

early 1900s. Following the stock market crash of 1929, Congress passed two pieces of legislation that continue to serve as the cornerstone of U.S. securities laws; Securities Act of 1933 and Securities Exchange Act of 1934.

2.2. Securities Act of 1933

The Securities Act of 1933 was the first major piece of federal legislation regarding the sale of securities. Prior to this legislation, the sale of securities was primarily governed by state laws referred to as blue sky laws (Seitzinger, et al., 2002). The Securities Act of 1933 had two main goals: (1) to ensure more transparency in financial statements so investors can make informed decisions about investments, and (2) to establish laws against misrepresentation and fraudulent activities in the securities markets. It is largely a disclosure law, requiring issuers of securities to disclose information that purportedly allows investors to make informed investment decisions. In addition to its disclosure provisions, the 1933 Act also prohibits the fraudulent sale of registered securities (www.sec.gov).

2.3. Securities Exchange Act of 1934 and the Maloney Act of 1938

While the 1933 Securities Act focused on primary markets, ensuring disclosure of pertinent information relating to publicly offered securities, the 1934 Securities Exchange Act focused on secondary markets, ensuring that parties who trade securities—exchanges, brokers and dealers—act in the best interests of investors. Certain securities—including US Treasury and municipal debt—were largely exempt from either act's provisions (Holton, 2002). Provisions of the 1934 provide for the creation of (i) the Securities Exchange Commission (SEC); (ii) a system for regulating the markets themselves and those who trade in those markets; (iii) a continuous disclosure system for issuers; and (iv) anti-fraud provisions (www.sia.com).

The Securities Exchange Act of 1934 was created to provide governance of securities transactions on the secondary market (after issue) and regulate the exchanges and broker-dealers in order to protect the investing public. All companies listed on stock

exchanges must follow the requirements set forth in the Securities Exchange Act of 1934. Primary requirements include registration of any securities listed on stock exchanges, disclosure, proxy solicitations and margin and audit requirements. From this act the SEC was created. The SEC's responsibility is to enforce securities laws (www.investopedia.com). SEC, which is an independent federal agency, is granted by the 1934 Act broad authority over all aspects of the securities industry and markets. Congress intended the SEC to be the regulator that establishes national policy over the Nation's securities markets. The Commission adopts rules implementing the provisions of the federal securities laws. The SEC also cooperates with the U.S. Department of Justice (DOJ), which has responsibility for criminal enforcement of the federal securities laws, and with state securities officials (www.sia.com).

The 1938 Maloney Act, which extended the SEC's regulatory jurisdiction to the Over-the-Counter (OTC) market, is related to the regulatory authority of SEC over securities firms, which include investment banks as well as non-banks that broker and/or deal non-exempt securities. This act provided for self regulating organizations (SRO's) to provide direct oversight of securities firms under the supervision of the SEC (Holton, 2002).

The establishment of the Securities Commission through the Securities Act in 1933, the Securities Exchange Act in 1934 and the establishment of the National Association of Securities Dealers by means of the Maloney Bill to the Exchange Act in 1938 created a system of regulation and supervision over brokers, dealers and the OTC markets (www.nbs.sk).

3. Foreign Corrupt Practices Act (FCPA) of 1977

Congress enacted the FCPA in 1977, in response to recently discovered but widespread bribery of foreign officials by U.S. business interests. Congress resolved to interdict such bribery, not just because it is morally and economically suspect, but also because it was causing foreign policy problems for the U.S.. In particular, these concerns arose from revelations that

U.S. defense contractors and oil companies had made large payments to high government officials in Japan, the Netherlands, and Italy (Martin, 2004).

FCPA originally prohibited U.S. corporations and U.S. nationals from making improper payments to foreign officials, parties or candidates, in order to assist a company in obtaining, retaining or directing business to any person. It also imposed record-keeping and internal controls requirements on all companies subject to SEC jurisdiction (Tarun, 2006). The FCPA sets forth provisions on record-keeping and accounting practices by U.S. companies, aimed at prohibiting the establishment of corporate slush funds used to finance illegal payments. The record-keeping and accounting provisions apply to all U.S. companies that are "issuers" – those that have stock registered with the SEC – and not just those with foreign operations. The anti-bribery provisions of the FCPA apply to all companies, regardless of whether they have stock registered with the SEC (Martin, 2004).

While the act provided U.S. companies with a shield against requests for improper payments, in some cases it also put them at a competitive disadvantage. As U.S. companies trading and investing abroad faced increased foreign competition in the 1980s, the absence of any parallel anti-bribery restrictions on foreign companies (excluding those few subject to U.S. law by virtue of listings on U.S. stock exchanges) meant that U.S. companies stood to lose business to foreign competitors willing to bribe or to close their eyes to the practices of their partners or agents. Although estimating such losses is difficult, a 1995 U.S. study approximated losses at \$45 billion in lost contracts alone. (Low, Trenkle, 1999).

3.1. The FCPA's Anti-Bribery Provisions

The FCPA antibribery provisions make it unlawful for any issuer, domestic concern, or person acting within the U.S. to offer or make a payment of anything of value directly or indirectly to a foreign official, international organization official, political party or party official, or any candidate for public office, for the purpose of influencing that official to

assist in obtaining or retaining business (15 U.S.C. § 78dd-1 to -3).

No explicit law existed, however, to deal with foreign officials before the FCPA of 1977. The enactment of the FCPA was prompted by a series of notorious scandals such as Watergate and one involving Lockheed Martin Aircraft Corporation. The SEC-sponsored voluntary disclosure program in the 1970s revealed that more than 450 U.S. companies made “questionable or illegal payments” in excess of \$300 million to foreign government officials, politicians, and political parties. Such disclosures of widespread corporate wrongdoing increased the public anger against big companies, resulting in the passage of the FCPA in 1977 (Darrough, 2004).

3.2. The FCPA’s Accounting and Record-Keeping Provisions

In addition to the anti-bribery provisions, the FCPA imposes certain record-keeping and internal control requirements only on issuers. Essentially, these requirements mandate that publicly traded companies keep accurate books and records. Neither the record keeping nor internal control provisions limit themselves to transactions above a certain amount or impose a materiality requirement (Tarun, 2006).

The FCPA's accounting provisions were added to the Act in 1994. They require all companies that are securities issuers under the Securities Exchange Act of 1934, whether domestic or foreign, to maintain record-keeping and disclosure requirements in order to prevent "off-book" accounting practices that facilitate bribery. The FCPA's books and records provisions apply to all U.S. and foreign companies that are issuers under the Act (Martin, 2004).

The FCPA’s accounting provisions require companies with securities listed in US trading markets to keep books, records, and accounts, which accurately and fairly reflect any transaction and disposition of assets in reasonable detail, and to maintain an adequate system of internal accounting controls (15 U.S.C. § 78m(b)). The accounting provisions require: (1) good bookkeeping and disclosure, and (2) maintenance of the internal control system, which ensures that: (a)

transactions are executed in accordance with management's general or specific authorization; (b) 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; (c) access to assets is permitted only in accordance with management's general or specific authorization; and (d) the recorded accountability for assets is compared with the existing assets at reasonable intervals and appropriate action is taken with respect to any differences (Darrough, 2004).

The FCPA amended Section 13(b) of the Securities Exchange Act of 1934 and codified the accounting provisions along the lines of Statement of Auditing Procedure (SAP) No. 54. Since the accounting provisions were passed as amendments to the 1934 Act (unlike the anti-bribery requirement), they apply to all corporations subject to the SEC regulation, regardless of whether they are engaged in foreign business. In effect, the FCPA granted the SEC authority over the entire financial management and reporting requirements of SEC registrants (Lacey and George, 1998).

3.3. Enforcement and Penalties for Violations of the FCPA

The FCPA divides enforcement responsibilities between the DOJ and the SEC. Penalties for FCPA violations may be civil and/or criminal. Penalties for criminal violations are determined according to the U.S. Sentencing Guidelines Manual and include imposition of fines against companies and/or individuals -- i.e. directors, managers, employees -- as well as imprisonment (Martin, 2004). Enforcement responsibilities for the FCPA are divided between the DOJ and the SEC. The DOJ is responsible for all criminal enforcement of the FCPA provisions and for civil enforcement of the anti-bribery violations (Section 30A of the Securities Act of 1934) with respect to domestic concerns and foreign companies and nationals. The SEC is responsible for civil enforcement of both the anti-bribery and accounting provisions with respect to the issuers of securities. The SEC enforces the record-keeping (“books and records”) violations

(Section 13(b)(2)(A) of the Securities and Exchange Act) and internal control violations (Section 13(b)(2)(B)), and has authority to obtain civil injunctions against future violations of the FCPA by issuers.

Violations of the FCPA's anti-bribery provisions may result in criminal fines of up to \$2 million for entities and criminal fines up to \$250,000 and/or imprisonment for up to five years for individuals. If the violation results in pecuniary gain or loss for any person, an alternative statutory maximum fine equal to the greater of twice the gross gain or loss is authorized. For violations of the FCPA's accounting provisions, the SEC may issue a cease and desist order, order an accounting or disgorgement and/or impose civil penalties of up to \$500,000 for entities and \$100,000 for individuals. "Willful" violations of the FCPA's accounting provisions may result in criminal fines of up to \$25 million for entities and criminal fines up to \$5 million and/or imprisonment for up to 20 years for individuals (Warin, Monahan, 2005).

3.4. FCPA Amendments of 1988

Internationalizing antibribery rules had long been a goal of U.S. policymakers. In 1988, as part of the Omnibus Trade and Competition Act that produced some minor amendments to the FCPA (Pub. L. No. 100-418, 102 Stat. 1107, 1415-25 (1988)), Congress mandated the administration to attempt to negotiate multilateral antibribery rules. Although such efforts had failed in the 1970s, by the 1990s, changed world perceptions of the costs of corruption made possible what had previously been unthinkable (Low, Trenkle, 1999).

4. Anti-Bribery Conventions and Their Impact on US Legislations

With respect to the issue of transnational bribery, the U.S. stood alone for twenty-five years in criminalizing, through the FCPA and international cooperation in the investigation and prosecution of cases was limited by both legal and practical barriers, including requirements of dual criminality, bank secrecy, and a lack of experience of prosecutors in dealing with the complexities of transnational

corruption offenses, as well as a lack of political will in many countries. By the early 1990s, a variety of events began to change the domestic and international political dynamic with respect to the issue of corruption. International businesses became increasingly aware of the costs of corruption, and governments and international organizations became increasingly sensitive to the distortions it created. (Low, 2006).

4.1. OECD Anti-Bribery Convention

Largely owing to consistent complaints by the US, in late 1997 the Organisation for Economic Cooperation and Development (OECD) concluded the thirty four country Convention, which was immediately joined by all 29 OECD member and 5 non-member States (Gounari, 2001). The OECD Convention entered into force on February 15, 1999. On July 27, 2000, the U.S. Senate gave its advice and consent to ratification of the OECD Convention, clearing the way for the U.S. to join one of its international anticorruption treaty. The OECD Convention entered into force as to the U.S. on October 29, 2000 (Martin, 2004). By 2004, all 35 signatories had ratified the OECD Convention and had approved legislation to implement the Convention. In the U.S., the International Anti-Bribery and Fair Competition Act of 1998 amended the FCPA to implement the OECD Convention. Other countries have similarly adopted legislation, which vary widely on many significant points. As a result, corporations conducting international business must scrutinize carefully the law in each OECD country where they do business (Tarun, 2006).

The 1998 Amendments to the FCPA modify its antibribery provisions in five significant respects, four of which were driven by the desire to conform the FCPA to the OECD Convention. (The 1998 Amendments do not affect the books and records and internal control provisions of the FCPA. 15 U.S.C. § 78m.) The 1998 Amendments:

- broaden the jurisdictional reach of the act over non-U.S. persons acting within the U.S.;

- broaden the jurisdictional reach over U.S. persons acting outside the U.S.;

- expand the FCPA to cover payments made to secure "any improper advantage," incorporating a broader definition of business activities covered by the FCPA;

- expand the definition of "foreign officials;" and

- eliminate the exemption of certain non-U.S. nationals from criminal penalties

The amendments expand the definition of "foreign official" to cover officials or employees of public international organizations — such as the United Nations, World Bank or other international financial institution. The original FCPA defined "foreign official" as "any officer or employee of a foreign government or any department, agency or instrumentality thereof, or any person acting in an official capacity for or on behalf of any such government or department, agency, or instrumentality." (15 U.S.C. §§ 78dd-1(f)(1), 78dd-2(h)(2).)

Except the OECD Convention, the OECD has recently developed the "Principles of Corporate Governance" to assist member and non-member governments in their efforts to "evaluate and improve the legal, institutional and regulatory framework for corporate governance" and to "provide guidance and suggestions" for various stakeholders in corporate governance (Darrough, 2004).

The Millstein Report prepared by the OECD's Business Sector Advisory Group on Corporate Governance (chaired by Ira M. Millstein) details four core governance standards necessary to attract private capital: (www.oecd.org)

- Fairness. Protect shareholder rights, including the rights of minority and foreign shareholders (and the contractual rights with resource providers).

- Transparency. Require timely disclosure of adequate, clear, and comparable information concerning corporate financial performance, corporate governance, and corporate ownership.

- Accountability. Clarify governance roles and responsibilities, and ensure that managerial and shareholder interests are aligned and monitored by the board of directors.

- Responsibility. Ensure corporate compliance with the other laws and regulations that reflect the respective society's values.

Issued to OECD Ministers at the height of the Asian crisis, the Report recommended that the OECD promote and further articulate these core standards. The OECD Principles of Corporate Governance issued in 1999 expand the four core standards into five broad and non-binding principles: The corporate governance framework should: (Gregory, 2001)

- Protect shareholders' rights.

- Ensure the equitable treatment of all shareholders, including minority and foreign shareholders. All shareholders should have the opportunity to obtain effective redress for violation of their rights.

- Recognize the rights of stakeholders as established by law and encourage active cooperation between corporations and stakeholders in creating wealth, jobs, and the sustainability of financially sound enterprises.

- Ensure that timely and accurate disclosure is made on all material matters regarding the corporation, including the financial situation, performance, ownership, and governance of the company.

- Ensure the strategic guidance of the company, the effective monitoring of management by the board, and the board's accountability to the company and the shareholders.

In 2004, the principles were revised to reflect more fully the changes that have occurred in the corporate governance landscape, especially after the corporate crisis in America.

4.2. The Organization of American States (OAS) Inter-American Convention against Corruption

In 1996, Latin American countries signed the first international anticorruption treaty — the Inter-American Convention Against Corruption, which came into force in 1997. Twenty-three countries have signed the convention, and twenty-nine countries have ratified the convention. Similar to the FCPA, the Organization of American States (OAS) Inter-American Convention Against Corruption requires parties to criminalize the bribery of foreign officials. To serve its purpose of preventing, detecting, punishing and eradicating corruption, the OAS Convention calls for cooperation among countries in the fight against domestic and transnational corruption. The convention requires that member states afford one another the “widest measure of mutual assistance” in the criminal investigation and prosecution of such acts. As a result, parties must extradite individuals that violate another country’s anti-corruption laws. Moreover, member states cannot invoke bank secrecy as a basis for refusing to assist another state (Tarun, 2006).

4.3. United Nations Convention Against Corruption

The United Nations Convention Against Corruption (UN Convention), the first global treaty to address corruption, represents an attempt to establish universal anticorruption standards, including a common set of obligations on the part of countries around the world to cooperate in investigations and enforcement. After preparatory work in 2001, negotiations began in early 2002. They were concluded with the adoption of the text of the Convention in the fall of 2003. The Convention was opened for signature in Merida, Mexico, on December 9, 2003, and entered into force on 14 December 2005 (Low, 2006). As of April 2007, 140 countries had signed the Convention, and 91 had ratified it (www.unodc.org).

4.4. Council of Europe’s Criminal Law Convention on Corruption (COE’s Criminal Law Convention) 1998

The Council of Europe’s Criminal Law Convention on Corruption (COE Criminal Law Convention) was negotiated by the Member States with

the participation of observers, including the U.S.. It was adopted in 1998 by the Council of Ministers. The COE Criminal Law Convention entered into force on July 1, 2002. As of May 1, 2004, of the forty-seven signatories to the convention, twenty-nine have ratified it. The U.S. has signed but not yet ratified the COE Criminal Law Convention (Deming, 2005).

5. Sarbanes-Oxley Act of 2002

In response to recent corporate accounting and fraud scandals, in 2002, Congress passed the Sarbanes-Oxley Act (“Sarbanes-Oxley”), which made sweeping reforms in various aspects of corporate governance. The Sarbanes–Oxley Act of 2002 will be a vivid reminder of the importance of due professional care and financial integrity. This act is a major reform package mandating the most far-reaching changes Congress has imposed on the business world since the FCPA of 1977 and the SEC Act of the 1930s. It seeks to thwart future scandals and restore investor confidence by, among other things, creating a Public Company Accounting Oversight Board revising auditor independence rules, revising corporate governance standards, and significantly increasing the criminal penalties for violations of securities laws (Gallegos, 2003).

Sarbanes Oxley aims to enhance corporate governance through measures that will strengthen internal checks and balances and, ultimately, strengthen corporate accountability. Sarbanes Oxley requires companies to perform a risk assessment of current information security policies to establish the extent to which such policies need updating so as to support the integrity of corporate financial information. Its major provisions include (O’Conor, 2005):

- certification of financial reports by Chief Executive Officers and Chief Financial Officers;
- ban on personal loans to Executive Officers and Directors;
- accelerated reporting of trades by insiders;
- prohibition on insider trades during pension fund blackout periods;

- civil penalties added to disgorgement funds for the relief of victims;

- additional disclosure;

- auditor independence, including outright bans on certain types of work and pre-certification by the company's Audit Committee of all other non-audit work; and

- criminal and civil penalties for securities violations.

Sarbanes-Oxley significantly increased the penalties for willful violations of the Securities and Exchange Act of 1934, including the accounting provisions of the FCPA (penalties for violations of the antibribery provisions of the FCPA were not affected by Sarbanes-Oxley). The maximum penalty for violations by individuals was increased to a fine of not more than \$5 million (from \$1 million) and/or up to 20 years imprisonment (from 10 years). Maximum fines for violations by a corporation increased from \$2.5 million to \$25 million (Fielding, 2004).

Conclusion

Corporate governance issues are receiving greater attention in both developed and developing countries as a result of the increasing recognition that a firm's corporate governance affects both its economic performance and its ability to access long term, low cost investment capital. The main idea of corporate governance is ensuring that investors receive a fair return on their investment by having a certain protection against management abuse or poor use of their investment capital.

From the 1930's various regulations related to corporate governance have been made in the U.S.. The Securities Act of 1933 and the Securities Exchange Act of 1934 have been regarded as the first regulations about corporate governance, followed by FCPA in 1977, which had been the only regulation all over the world for the following 20 years. The recent development related to corporate governance is the Sarbanes-Oxley Act of 2002. This act not only dramatically changed the regulatory landscape for companies that participate in U.S. capital market, but also affected other countries all over the world. By this

act, the U.S. Congress imposed major corporate governance and disclosure reforms and created an entirely new regulatory scheme for the the accounting profession, among other things.

Corporate governance will continue to be the main tool in protecting stakeholders' rights in the future, as well. By examining the evolution of corporate governance in U.S., it can be stated that regulations related to corporate governance practices have become more organized and challenging. Companies need to adopt themselves to these in order to survive.

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The Securities Act of 1933

Securities Exchange Act of 1934

Foreign Corrupt Practice Act of 1977

Sarbanes-Oxley Act of 2002