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Is SEC Heading Toward Strict-Liability Enforcement of the Foreign Corrupt Practices Act?

by Thomas R. Fox

A number of recent developments indicate that at least one federal agency with enforcement responsibility for the Foreign Corrupt Practices Act (FCPA) is moving toward a strict-liability interpretation of the law. While wide disagreement may exist as to whether the FCPA warrants such an application, the implications of strict-liability enforcement are sufficiently significant that corporations' Chief Compliance Officers and private compliance practitioners should be preparing to address it.

The Department of Justice (DOJ) and the Securities and Exchange Commission (SEC) share responsibility for FCPA enforcement. DOJ is unlikely to successfully pursue strict-liability application of the FCPA because the law requires that prosecutors prove specific intent. A confluence of events, enforcement actions, and senior officials' FCPA-related statements, however, indicate that SEC is laying the groundwork for a no-intent standard for violations of civil internal control rules. Under such a theory, companies whose internal compliance control regimes are investigated would have to demonstrate that they meet some minimum standard that satisfies the SEC. If the SEC is not satisfied, it will file an administrative complaint alleging failure to maintain appropriate internal controls as required by the FCPA. In response to that complaint, companies will have the burden to prove that they have designed and implemented effective systems of internal compliance controls.

FCPA Internal Control Rules. The FCPA's internal control provisions are one part of its Accounting Provisions requirements. The second part of the Accounting Provisions are the books and records provisions, which generally provide that a company's books and records must accurately reflect its financial transactions. The statute itself does not explicitly predicate a violation of the SEC Accounting Provisions, including internal controls, on an offer or payment of a bribe or any other corrupt act.

The FCPA's internal control rules require that companies 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;
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> (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;

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> (iii) access to assets is permitted only in accordance with management's general or specific authorization; and
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> (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.[1]
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> As DOJ's FCPA Guidance further explains:
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> the Act defines 'reasonable assurances' as 'such level of detail and degree of assurance as would satisfy prudent officials in the conduct of their own affairs.' The Act does not specify a particular set of controls that companies are required to implement. Rather, the internal controls provision gives companies the flexibility to develop and maintain a system of controls that is appropriate to their particular needs and circumstances.[2]

Smith & Wesson Order. SEC's July 28, 2014 Cease-and-Desist Order filed against Smith & Wesson (S&W)[3] provides one indication of the Commission's movement toward strict-liability FCPA enforcement. Nothing in the reported settlement documents tied the alleged failure of S&W internal controls to the payment of (or offer to pay) a bribe or the obtaining of any benefit. The Order detailed SEC's claims as follows: "Despite making it a high priority to grow sales in new and high risk markets overseas, the company failed to design and implement a system of internal controls or an appropriate FCPA compliance program reasonably designed to address the increased risks of its new business model."[4] S&W notably did not "admit or deny" any of the allegations made against it; the company simply consented to the entry of the Order.

SEC further stated in its Order, "Smith & Wesson failed to devise and maintain sufficient internal controls with respect to its international sales operations. While the company had a basic corporate policy prohibiting the payment of bribes, it failed to implement a reasonable system of controls to effectuate that policy."[5] Additionally, the company did not "devise and maintain a system of internal accounting controls sufficient to provide reasonable assurances that transactions are executed in accordance with management's general or specific authorization; transactions are recorded as necessary to maintain accountability for assets, and that access to assets is permitted only in accordance with management's general or specific authorization."[6]

SEC reached these conclusions, however, without providing any evidence of bribes paid by S&W for the purpose of obtaining or retaining business—an unprecedented application of the FCPA's Accounting Provisions in a strict-liability fashion. The Chief of the FCPA Unit of SEC's Enforcement Division, Kara Brockmeyer, added an exclamation point to the Commission's message in bringing this case, stating in SEC's accompanying press release that "'This is a wake-up call for small and medium-size businesses that want to enter into high-risk markets and expand their international sales. When a company makes the

[1] Securities and Exchange Act of 1934, 15 U.S.C. § 78m(b)(2)(B).
[2] *A Resource Guide to the U.S. Foreign Corrupt Practices Act* (Nov. 2012), at 40, available at http://www.justice.gov/criminal/fraud/fcpa/guidance/guide.pdf.
[3] Securities and Exchange Commission, Order Instituting Cease-and-Desist Proceedings Pursuant to Section 21c of the Securities Exchange Act of 1934, *In re Smith & Wesson Holding Corp.*, Release No. 72678, available at http://www.sec.gov/litigation/admin/2014/34-72678.pdf.
[4] *Id*. at 3.
[5] *Id*. at 5.
[6] *Ibid*.

strategic decision to sell its products overseas, it must ensure that the right internal controls are in place and operating.'"[7]

Influential Internal Audit Framework. The latest update of a private-sector organization's audit framework document provides a second indication that a strict-liability standard for FCPA internal controls is emerging. The Committee of Sponsoring Organizations of the Treadway Commission (COSO), formed by five U.S. accounting and auditing industry associations in 1987, issued an update to its influential *Internal Control—Integrated Framework*[8] in May, 2013. The Framework, which had not been updated since 1992, formally took effect in December, 2014.

In a 2013 book[9], COSO Chairman Emeritus Larry Rittenberg wrote that the original COSO framework from 1992 has stood the test of time "because it was built as a conceptual framework that could accommodate changes in (a) the environment, (b) globalization, (c) organizational relationship and dependencies, and (d) information processing and analysis."[10] Moreover, the updated 2013 Framework was based upon four general principles which include the following:

> (1) the updated Framework should be conceptual, which allows for updating as internal controls (and compliance programs) evolve; (2) internal controls are a process which is designed to help businesses achieve their business goals; (3) internal controls apply to more than simply accounting controls; they apply to compliance controls and operational controls; and (4) while [compliance] all starts with Tone at the Top, the responsibility for the implementation of effective internal controls resides with everyone in the organization.[11]

The fourth point speaks directly to the need for in-house and external compliance specialists to be involved in the design and implementation of internal controls for compliance, and not simply for companies to rely on their accounting, finance, or internal audit function to handle that responsibility.

The updated COSO Framework also offers SEC a precise model it can follow when inquiring about companies' internal compliance controls. How many companies would be able to not only present evidence of implementation of internal controls along the lines of the updated Framework, but also evidence of their *effectiveness*? Unfortunately the answer is not many.

Sarbanes-Oxley Act § 404. Section 404 of the Sarbanes-Oxley Act (SOX)[12] requires public companies to report to SEC on the adequacy of the company's internal controls on financial reporting. The report must affirm management's responsibility for establishing and maintaining an adequate internal control structure and procedures for financial reporting. It must also contain an assessment, as of the end of the company's most recent fiscal year, of the *effectiveness* of its internal control structure and procedures for financial reporting. External auditors must also assess and make such a report. When preparing reports under SOX § 404, most companies, and their external auditors, have traditionally utilized the COSO Framework.

[7] Securities and Exchange Commission Press Release, *SEC Charges Smith & Wesson With FCPA Violations*, July 28, 2014, available at http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370542384677#.VRVi-uEyjUI.
[8] *See* Executive Summary, available at http://www.coso.org/documents/990025P_Executive_Summary_final_may20_e.pdf.
[9] Larry Rittenberg, Ph.D, COSO Internal Control—Integrated Framework: Turning Principles Into Positive Action (IIA Research Fndt. 2013).
[10] *Id*. at 3.
[11] *Id*. at 3-4.
[12] Sarbanes-Oxley Act of 2002, 18 U.S.C. § 7262.

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All of the above factors can lead to the following situation arising from SOX § 404 compliance: A company's external auditors issue their compliance report, and the company in turn makes that report public. SEC reviews the report and concludes that the company's internal compliance controls regarding bribery and corruption are insufficient under the FCPA. The Commission then requests evidence of the company's development and implementation of internal controls, and also asks for its audited evidence of effectiveness. The company responds in due course. It then receives another letter from SEC, which pronounces that the company has not proven to the Commission's satisfaction that the internal controls are effective. The letter includes a proposed FCPA Administrative Order with a substantial suggested monetary fine. The company protests in response that SEC's proposed Order contains no allegations of bribery or corruption regarding the Commission's claimed flaws in the internal compliance controls. Ignoring the protest, SEC indicates its intent to proceed with its charges, "inviting" the company to contest the proposed Order in the SEC administrative process.

With a strict-liability standard for adjudging what the SEC considers sufficient internal controls under the FCPA, a company could find itself penalized under the FCPA with no evidence of a bribe ever being paid or even having been offered.

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