Internal Controls and Strict Liability Under the FCPA

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Doing Compliance

What Are Internal Controls

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What Are Internal Controls

Internal controls are policies, procedures, monitoring and training that are designed to ensure that company assets are used properly, with proper approval and that transactions are properly recorded in the books and records. While it is theoretically possible to have good controls but bad books and records (and vice versa), the two generally go hand in hand – where there are record-keeping violations, an internal controls failure is almost presumed because the records would have been accurate had the controls been adequate.

Source: Aaron Murphy-Foreign Corrupt Practices Act
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Strict Liability for Internal Control Violations Under the FCPA

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The Act

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

The Act (con’t)

(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;
No Criminal Liability?

(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).

Strict Liability

- No tie to criminal actions
- No tie to payment of bribe or offer to pay bribe
- Profit disgorgement-Penny Stock Reform Act of 1991
- SEC mining of 10Ks
- SEC administrative proceedings
Oracle

■ Head-scratcher?
■ No evidence of bribe paid
■ Marketing funds parked in bank account of distributor

Enforcement Actions Relating to Internal Controls
**Smith & Wesson**

- No DOJ prosecution
- No internal controls present when company went overseas
- S&W did not contest charges in Administrative Proceeding

**Layne Christensen**

- Declination by DOJ
- Mischaracterization of payments
- No check with second set of eyes
Bio-Rad

- Criminal enforcement but no proof of bribery?
- NPA given to company
- Failure/Over-ride of internal controls outside of US
- Mike Volkov calls this the most significant enforcement action of 2014

Internal Controls for FCPA Compliance
General

- Anti-bribery and anti-corruption training and employee certifications are a good **start**.
- Certain types of transactions and processes require a Compliance-focused evaluation in consideration of the current prosecution environment.
- Many companies have not specifically evaluated Compliance-related controls, even if they have conducted anti-bribery training and have issued policies designed to prevent payment of bribes.

General cont’d

- Keep detailed books and records that fairly reflect transactions and dispositions of assets.
- Devise and maintain internal accounting controls that provide reasonable assurance that:
  - Transactions are properly **authorized**
  - Transactions are **accurately recorded**
  - **Accountability** for assets is maintained
  - **Unauthorized access** to assets is prevented
Effective controls

“Effective Controls” means:

- The controls are well designed to meet the specific control objectives, and
- The internal control system includes measures to ensure the controls are consistently and accurately performed.

Third Parties-Segregation of Duties

- A control to correlate the approval of payments made to contracts with third party representatives and your company’s internal system for processing invoices.
- A control to monitor all situations in which funds can be sent outside the US, in whatever form your company might use, which could include accounts payable computer checks, manual checks, wire transfers, replenishment of petty cash, loans, advances or other forms.
- A control for the approval of sales discounts to distributors.
- A control for the approval of accounts receivable write-offs.
- A control for the granting of credit terms to third parties or customers outside the US.
- A control for agreements for re-purchase of inventory sold to third parties or customers.
- A control for opening of bank accounts specifically including accounts opened at request of an agent or a customer.
- Execution and modification of contracts and agreements outside the US.
Third Parties-Delegation of Authority

- A control for the structure and enforcement of the Delegation of Authority.
- A control for the maintenance of the vendor master file.
- A control around expense reports received from third parties.
- A control for gifts, entertainment and business courtesy expenditures by third party representatives.
- Charitable donations.
- All cash / currency, inventory, fixed asset transactions, and contract execution in countries outside the US where the country manager has final authority.

Gifts, Travel and Entertainment

- Strong approval over expense reports can stop fraud before it occurs
- Second set of eyes on corp travel department
- Multiple gifts/dinner with same gov official
- Remember GSK
Foreign Business Units

- Must control petty cash
- Documented receipts for payments out of petty cash must be reviewed
- Offshore payment approvals
- Oversight of Country Manager

COSO 2013-What Does It Mean Going Forward?
The COSO Cube

2013 Framework articulates 17 principles for effective internal control

- Control Environment
  1. Demonstrates commitment to integrity and ethical values
  2. Exercises oversight responsibility
  3. Establishes structure, authority and responsibility
  4. Demonstrates commitment to competence
  5. Enforces accountability

- Risk Assessment
  6. Specifies suitable objectives
  7. Identifies and analyzes risk
  8. Assesses fraud risk
  9. Identifies and analyzes significant change

- Control Activities
  10. Selects and develops control activities
  11. Selects and develops general controls over technology
  12. Deploys through policies and procedures

- Information & Communication
  13. Uses relevant information
  14. Communicates internally
  15. Communicates externally

- Monitoring Activities
  16. Conducts ongoing and/or separate evaluations
  17. Evaluates and communicates deficiencies
Five Elements of an Effective Compliance Program

- Leadership
- Risk Assessment
- Standards and Controls
- Training and Communication
- Monitoring, Auditing and Response

The Essential Ingredients of Corporate Compliance

<table>
<thead>
<tr>
<th>USSG's 7 Elements of an Effective Compliance Program</th>
<th>13 Good Practices by the OECD on Internal Controls, Ethics, and Compliance</th>
<th>Ten Hallmarks of an Effective Compliance Program</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Standards and procedures to prevent and detect criminal conduct</td>
<td>1. Risk assessment as basis for effective internal controls and compliance program</td>
<td>1. Tone at the Top</td>
</tr>
<tr>
<td>2. Leaders understand / oversee the compliance program to verify effectiveness and adequacy of support; specific individuals vested with implementation authority / responsibility</td>
<td>2. Policy that clearly and visibly states bribery is prohibited</td>
<td>2. Written Controls</td>
</tr>
<tr>
<td>3. Deny leadership positions to people who have engaged in misconduct</td>
<td>3. Training – periodic, documented</td>
<td>3. Oversight, autonomy &amp; resources</td>
</tr>
<tr>
<td>4. Communicate standards and procedures of compliance program, and conduct effective training.</td>
<td>4. Responsibility – individuals at all levels should be responsible for monitoring</td>
<td>4. Risk Assessments</td>
</tr>
<tr>
<td>5. Monitor and audit; maintain reporting mechanism</td>
<td>5. Support from senior management – strong, explicit and visible</td>
<td>5. Training and Continuous Advice</td>
</tr>
<tr>
<td>6. Provide incentives; discipline misconduct</td>
<td>6. Oversight by senior corporate officers with sufficient resources, authority, and access to Board</td>
<td>6. Hiring, incentives and disciplinary measures</td>
</tr>
<tr>
<td>7. Respond quickly to allegations and modify program</td>
<td>7. Specific risk areas – promulgation and implementation programs to address key issues</td>
<td>7. Third Parties</td>
</tr>
</tbody>
</table>

NOTE: A general provision requires periodic assessment of risk of criminal conduct and appropriate steps to design, implement, or modify each element to reduce risk

- 8. Business partners due diligence
- 9. Accounting – effective internal controls for accurate books and records
- 10. Guidance – provision of advice to ensure compliance
- 11. Reporting violations confidentially with no retaliation

Original Source
Paul J. McNulty
Slide 27

HU1  Can we source these five elements back to someone? Is this Baker McKenzie's five-step program?
Haymarket User, 11/11/2014

Slide 28

HU2  Honestly, this slide looks too messy. I’d suggest just listing the three sources of guidance without these colored tiles of steps. It overwhelms.
Haymarket User, 11/11/2014
2013 Framework clarifies requirements for an effective system of internal control

An effective system of internal control requires:
- Each of the five components of internal control and relevant principles is present and functioning
- The five components are operating together in an integrated manner

Components are present and functioning if each relevant principle is determined to be present and functioning (e.g., no material weakness exists)

Relevant principles are present and functioning if persuasive evidence exists that controls are selected, developed and deployed to effect them

Components operate together when:
- Components are present and functioning
- Internal control deficiencies aggregated across components do not result in the determination that one or more material weakness exist

2013 Framework describes points of focus for each principle, for example...

<table>
<thead>
<tr>
<th>Principles</th>
<th>Control Environment</th>
</tr>
</thead>
<tbody>
<tr>
<td>Principle 1</td>
<td>Demonstrates Commitment to Integrity...</td>
</tr>
<tr>
<td>Principle 2</td>
<td>Exercises Oversight Responsibility...</td>
</tr>
<tr>
<td>Principle 3</td>
<td>Establishes Structures Authority...</td>
</tr>
<tr>
<td>Principle 4</td>
<td>Demonstrates Commitment to Competence...</td>
</tr>
</tbody>
</table>

Points of Focus
- Sets the tone at the top
- Establishes standards of conduct
- Evaluates adherence to standards of conduct
- Addresses deviations in a timely manner
- Establishes oversight responsibility
- Applies relevant expertise
- Operates independently
- Provides oversight for the system of internal control
- Considers all structures of the entity
- Establishes reporting lines
- Defines, assigns and limits authorities and responsibilities
- Establishes policies and practices
- Evaluates competence and addresses shortcomings
- Attracts, develops, and retains individuals
- Plans and prepares for succession
Points of focus describe important characteristics of the principles, for example…

<table>
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<th>Component</th>
<th>Risk Assessment</th>
</tr>
</thead>
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<tr>
<td>Principles</td>
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<tr>
<td>Principle 6</td>
<td>Specifies suitable objectives</td>
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<td>Assesses fraud risk</td>
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<td>Principle 9</td>
<td>Identifies and analyzes significant change</td>
</tr>
</tbody>
</table>

### Points of Focus

- Complies with applicable accounting standards
- Considers materiality
- Reflects entity activities
- Includes entity, division, operating unit, and functions
- Analyzes internal / external factors
- Involves appropriate level of management
- Estimates significance of risks identified
- Determines how to respond to risks
- Considers various types of fraud
- Assesses incentive and pressures
- Assesses opportunities
- Assesses attitudes and rationalizations
- Assesses changes in external environment
- Assesses changes in business model
- Assesses changes in leadership

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**What Can You Do Right Now?**

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Ask yourself

■ How could bribes be paid in your company?

■ Do you have effective internal controls to prevent such bribes?

What should you do?

■ Identify your highest Compliance-related risks:
  ■ Location-specific risks
  ■ Transaction-specific risks
  ■ Process-specific risks
  ■ Inherent risks of your industry
  ■ Inherent risks due to the way your company does business
What should you do? (cont’d)

- Identify controls in place to mitigate the identified risks.
- See if the controls are really working.
- Develop a written plan how the Company will remediate the unmitigated risks over time.
- Begin execution of the plan and monitoring the effectiveness of the Compliance Program, including the internal controls.

Summary (cont’d)

- If a Company’s Internal Controls have not been evaluated in consideration of the current enforcement environment.
- *It is very likely the Company does not have sufficient effective controls to comply with the FCPA.*
Five Questions to Ask

1. What ERP / financial accounting software system is used? Is the same system used at each location where accounting is performed?
2. Who are the independent auditors and for how many years have they been performing audits for the Company?
3. Has there ever been an independent assessment of internal compliance controls, other than what is done in connection with the independent audit?
4. Has there ever been fraud detected in the Company?
5. When was the last time your compliance internal controls were assessed?