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The Foreign Corrupt Practices Act: Insights for Internal Auditors

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THE FOREIGN CORRUPT PRACTICES ACT:

Given the Securities and Exchange Commission's new focus on proactively fighting FCPA violations and its willingness to implicate officers as "control persons," now is a good time for internal auditors and audit committees to refresh their knowledge of the FCPA.

INSIGHTS FOR INTERNAL AUDITORS

AUDREY A. GRAMLING, DANA R. HERMANSON, AND HEATHER M. HERMANSON

"Nature's Sunshine has always maintained the highest ethical standards in the way we conduct our business, just as we are committed to the highest quality in the products we make and sell."¹

Douglas Faggioli, President and CEO of Nature's Sunshine Products (NSP) made the above remarks as he accepted, on behalf of NSP, a 2004 "100 Best Corporate Citizens" award from Business Ethics magazine. NSP received the award two years in a row. Less than two years later, NSP would discover a bribery scheme in its Brazil operations that would expose it to Securities

and Exchange Commission (SEC) enforcement under the Foreign Corrupt Practices Act (FCPA). Douglas Faggioli and the company's CFO, Craig Huff, along with NSP, would be plaintiffs in a class action lawsuit, and the SEC would fine each officer \$25,000. How did a company go from winning ethics awards to being implicated in a foreign bribery scandal?

NSP is a U.S. manufacturer of nutritional and personal care products that are distributed worldwide. According to SEC records, NSP established a subsidiary in Brazil in 1994, which became its largest foreign market. Around 2000, the Brazilian government changed its classification

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**THE COSTS OF
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of certain vitamins and supplements to medicines. NSP was not able to register some of its products under this new classification, so sales began to decline. In order to register and import more products in Brazil, NSP made undocumented cash payments to Brazilian customs brokers, some of which were ultimately paid to Brazilian customs officials. NSP's Brazilian subsidiary falsified its books and hid the nature of these payments in its filings with the SEC. NSP's internal investigation revealed internal control weaknesses, which likely led to the violations.

The SEC's action against NSP is an example of a growing focus on FCPA violations. A new surge by both the Department of Justice (DOJ) and the SEC in FCPA enforcement cases should make internal auditors and corporate leaders take notice. Since 2005, the FCPA unit of the DOJ has prosecuted more FCPA cases than were prosecuted in the first 28 years that the FCPA existed.² FCPA fines have risen from \$87 million in 2007 to \$1.2 billion in the first few months of 2010.³ In addition, FCPA-related indictments of individuals are on the rise, as are prison terms. In April of 2010, a former executive received a prison sentence of 87 months, the longest yet in an FCPA case.⁴

In prior years, limited corporate interest in the FCPA was understandable in light of generally low fines and limited personal accountability for FCPA violations. However, as discussed below, the current FCPA environment is one of potentially huge fines and costly investigations, along with potential personal culpability. Thus, the costs of FCPA violations appear to be rising dramatically. As a result, internal auditors should ensure that they (1) educate the board and executives about FCPA requirements; (2) develop an overall FCPA risk profile; (3) work with the audit committee to create an FCPA compliance policy; and (4) report FCPA violations immediately.

SEC efforts related to the FCPA

The SEC's Division of Enforcement recently announced a new specialized

unit within the Enforcement Division, *The Foreign Corrupt Practices Act* unit. In her introduction as FCPA unit chief, Cheryl Scarboro stated that the unit's primary mission is to be proactive in enforcing the FCPA. The unit's objective is to better understand the specialized practices that companies in different industries and regions use to commit FCPA violations, so that they may be more readily detected. Ms. Scarboro indicated that "the unit will leverage the efforts of the SEC, the Department of Justice and our foreign counterparts to level the playing field worldwide."⁵

The NSP case introduced above highlights the aggressive stance that the SEC is taking with FCPA cases. In July of 2009, the SEC settled charges against NSP and the two officers previously mentioned, Douglas Faggioli and Craig Huff. The SEC did not claim that the officers had direct involvement in or knowledge of the alleged misconduct, although media accounts of the case indicate that NSP's former audit firm had accused Douglas Faggioli of approving an improper payment.⁶ The SEC argued that the officers, in their positions as "control persons, violated the books and records and internal controls provisions of the securities laws in connection with the Brazilian cash payments."⁷

The related complaint states that the officers "failed to adequately supervise NSP personnel in 2000 and 2001 to make and keep books and records that accurately reflected in reasonable detail the state of registration of NSP products sold in Brazil and to [adequately] supervise NSP personnel in devising and maintaining a system of internal controls sufficient to have provided reasonable assurance that the registration of NSP products sold in Brazil was adequately monitored in 2000 and 2001."⁸ Without admitting or denying guilt, the officers consented to civil penalties of \$25,000 each. Given the SEC's focus on proactively fighting FCPA violations and its willingness to implicate officers as "control persons," now is a good time for internal auditors and audit committees to refresh their knowledge of the FCPA.

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FCPA requirements and enforcement trends

According to the U.S. Department of Justice (DOJ):

The antibribery provisions of the FCPA make it unlawful for a U.S. person, and certain foreign issuers of securities, to make a corrupt payment to a foreign official for the purpose of obtaining or retaining business for or with, or directing business to, any person. Since 1998, they also apply to foreign firms and persons who take any act in furtherance of such a corrupt payment while in the United States.

The FCPA also requires companies whose securities are listed in the United States to meet its accounting provisions . . . These accounting provisions . . . require corporations covered by the provisions to make and keep books and records that accurately and fairly reflect the transactions of the corporation and to devise and maintain an adequate system of internal accounting controls.⁹

While many corporate leaders likely have not paid much attention to the FCPA in quite some time, especially to the antibribery provisions, a July 2010 report by the law firm Gibson, Dunn & Crutcher LLP indicates significant growth in DOJ and SEC FCPA enforcement cases. The report offers several insights into the current state of FCPA enforcement and regulation:

- SEC enforcement cases related to FCPA violations have gone from five in 2005, eight in 2006, 20 in 2007, 13

in 2008, 14 in 2009, to nine in the first half of 2010.

- DOJ cases have gone from seven in 2005, seven in 2006, 18 in 2007, 20 in 2008, 26 in 2009, to 27 in the first half of 2010.
- Recent cases involve such companies as Daimler AG; BAE Systems plc; Technip S.A.; Innospec, Inc.; and NATCO Group, Inc.
- TRACE International reports the three countries whose officials are most often implicated as bribery recipients: China, Iraq, and Nigeria.¹⁰

In 2010, both the DOJ and the SEC have become proactive in their enforcement of the FCPA. For instance, in January of 2010, 22 executives and employees in the military and law enforcement products industry were indicted for engaging in schemes to bribe government officials to gain or retain business. The DOJ, working with the Federal Bureau of Investigation, engaged in an undercover sting operation to identify executives willing to pay bribes to fictitious African defense agents.¹¹ The undercover sting is a dramatic shift in focus from a passive to a more proactive approach to FCPA enforcement.

Similarly, this year the SEC and DOJ initiated FCPA investigations of seven large pharmaceutical companies, focusing on transactions occurring in Brazil, China,



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Germany, Italy, Poland, Russia, and Saudi Arabia.¹² As promised, the SEC's new FCPA unit appears to be targeting an industry that is often at the mercy of government officials in getting its products to market. In many countries, even doctors are government employees.

A recent Ernst & Young LLP (E&Y) survey of executives in numerous countries indicates that nearly one-quarter worked for organizations that recently had been asked for bribes to gain business.¹³ In addition, the E&Y survey indicates that many executives around the world know little about the FCPA—over half of the senior in-house counsel respondents were unfamiliar with the act. This finding suggests an opportunity to improve FCPA knowledge and compliance worldwide.

Internal audit's approach to addressing FCPA risks

Given the increasing frequency of FCPA sanctions, what can internal auditors do to mitigate the risk of FCPA violations, or to at least lessen their impact if violations occur? Internal audit can use a four-pronged approach: educate, profile, comply, and report.

Educate. First, internal auditors should educate the board and executives about the FCPA. Officers and directors should recognize that the SEC may hold them individually accountable for FCPA violations as a "control person." Section 20(a) of the Securities and Exchange Act of 1934 defines a "control person" as:

Every person who, directly or indirectly, controls any person liable under any provision of this title or of any rule or regulation thereunder shall also be liable jointly and severally with and to the same extent as such controlled person to any person to whom such controlled person is liable, unless the controlling person acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action.

Based on Section 20(a) and the recent enforcement action against two officers of NSP, it appears that direct involvement in a bribery scheme may not be a necessary condition for culpability. As a result, management's development and implementation of compliance policies,

which are discussed below, become crucial to avoiding charges.

Profile. Second, internal audit should ensure that the board, management, and internal audit understand where FCPA risks may lie. As the SEC and DOJ cast a wider net in defining FCPA culpability, companies must be attentive not only to direct risks, but also to risks that stem from relationships with distributors and subcontractors. This concern is especially true for companies that are experiencing business growth in typically more corrupt parts of the world.

KPMG's *Performing FCPA Risk Assessments—Knowing the Warning Signs* identifies key FCPA risk areas as including commissions, gifts, discounts, political contributions, fictitious entities, and other related concealment methods. KPMG also highlights particular risks when doing business in Latin America and Asia. PwC's *Economic Crime: People, Culture, and Controls—The 4th Biennial Economic Crime Survey* reports high bribery rates in Indonesia, Brazil, Russia, and India.

Multinational corporations that rely on contractors in these high-risk areas are especially exposed. Several current cases suggest that the DOJ and SEC are aggressively pursuing not only the multinationals and their contractors, but also customers. Panalpina, a Swiss shipping and logistics firm, and its customers, including Royal Dutch Shell PLC, are being investigated for FCPA violations. Companies are increasingly being cautioned to know what their agents are doing, as culpability extends beyond the main bribery source. Due to the Panalpina case, some are questioning whether companies have a "legal responsibility to monitor the activities of even the most-established contractors."¹⁴ Thus, internal auditors should consider their companies' relationships with agents and contractors.

Acquisitions are another risk area. Internal auditors should ensure their companies perform pre-acquisition due diligence on FCPA issues, as some organizations have purchased FCPA problems. Gibson, Dunn & Crutcher quotes Alice Fisher of the DOJ on what the DOJ

EXHIBIT 1 Selected FCPA and Anti-Bribery Resources¹

- U.S. Department of Justice - <http://www.usdoj.gov/criminal/fraud/fcpa/>
- United Nations Convention Against Corruption - <http://www.unodc.org/unodc/en/treaties/CAC/index.html>
- OECD Convention on Combating Bribery of Foreign Public Officials in International Business Transactions - http://www.oecd.org/document/21/0,3343,en_2649_34859_2017813_1_1_1_1,00.html
- U.S. Federal Sentencing Guidelines - http://www.ussc.gov/2005guid/8b2_1.htm
- The FCPA Blog - <http://www.fcpablog.com/>
- Transparency International - <http://www.transparency.org/>

Articles and Reports

- Aguilar, M. K. 2009. Siemens Educates on FCPA Controls (the Hard Way). *Compliance Week* (March): 36-37.
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- Ettinger, M.S. 2010. Auditing FCPA Compliance Risk. *The Internal Auditor* (October): 46-50.
- Gibson, Dunn & Crutcher. 2010. 2010 Mid-year FCPA Update. <http://www.gibsondunn.com/publications/pages/2010Mid-YearFCPAUpdate.aspx>
- Greenebaum, Doll & McDonald. 2008. Best Practices for Mitigating FCPA Risk. <https://greenebaum.encryptedssl.com/files/Uploads/Documents/RLBBestPractices.pdf>
- KPMG. 2009. Performing FCPA Risk Assessments — Knowing the Warning Signs.
- PwC. 2009. Corruption Crackdown. <http://www.pwc.com/us/en/foreign-corrupt-practices-act/publications/index.jhtml>
- Santangelo, B., G. Stein, and M. Jacobs. 2007. The Foreign Corrupt Practices Act: Recent Cases and Enforcement Trends. *Journal of Investment Compliance* (Vol. 8, No. 3): 31-55.

¹ All websites in Exhibit accessed on October 26, 2010.

expects companies to know before an acquisition:

- The extent to which the company's customers are government entities, including state owned companies;
- Whether the company is involved in any joint ventures with government entities;
- What government approvals and licenses the company needs to operate abroad, how it obtained them, and when they require renewal;

- The company's requirements relating to Customs in foreign countries and how it fulfills those requirements; and
 - The company's relationships with third party agents or consultants who interact with foreign officials on the company's behalf, including how those agents were chosen and vetted by the company.
- Failure to conduct appropriate due diligence can even lead to criminal

charges (e.g., the recent case of Frederic Bourke), as described in a report by the law firm Skadden, Arps, Slate, Meagher & Flom LLP.

The DOJ's position at trial provides important cautionary warnings regarding appropriate due diligence of investments and acquisitions in emerging markets. In particular, a significant portion of the government's case was based on evidence that Mr. Bourke failed to conduct significant due diligence of the investment in Azerbaijan, failed to ask an experienced law firm to conduct any such due diligence for him and ignored red flags that would have alerted him to the corrupt nature of the investment.¹⁵

Sometimes pre-acquisition due diligence is constrained by local laws and regulations. The U.S. DOJ issued Opinion Procedure Release 08-02 in June 2008, which offers a possible model for companies struggling to complete due diligence before an international acquisition, while seeking not to incur immediate FCPA exposure.¹⁶

By identifying the risk areas, internal audit, the board, and management should be able to develop an FCPA risk profile. This profile should be updated regularly as the company grows or operations change. The risk profile can be used to create appropriate compliance policies.

Comply. Thirdly, it is important to have an FCPA compliance policy. Lanny Breuer, Assistant Attorney General for the Criminal Division of the U.S. DOJ, identifies several characteristics of an effective compliance program:

1. A "tone at the top" conveying the seriousness of commitment by the board and CEO to the program.
2. A disciplinary system that not only punishes employees for noncompliance, but rewards employees (through promotion or bonuses) for ethical behavior.
3. A whistleblower program that insulates employees from retaliation.
4. A compliance function led by a senior-level manager who reports directly to the board.
5. A commitment to continuous review of the compliance program by internal audit and/or outside consultants.
6. An inclusion of all foreign business partners (e.g., agents, distributors,

resellers, and joint business partners) in the compliance function.¹⁷

Links to selected organizations' policies are provided below and may serve as starting points for developing a policy. In addition, many CPA firms, law firms, and others offer FCPA compliance-related services or advice (see Greenebaum, Doll & McDonald, *Best Practices for Mitigating FCPA Risk*).¹⁸

- Devon Energy —
<http://www.devonenergy.com/CorporateGovernance/Documents/Foreign%20Corrupt%20Practices%20Act.PDF>
- Enterasys—<http://secure.enterasys.com/corporate/governance/fcpa.html>
- Manpower—
<http://www.manpower.com/about/documentdisplay.cfm?DocumentID=5302>
- Rochester Institute of Technology—
<http://finweb.rit.edu/legalaffairs/fpca.html>
- Willbros Group—
<http://www.willbros.com/fw/main/Foreign-Corrupt-Practices-Act-Compliance-Policy-95.html>

Internal audit should treat an FCPA compliance program like any other internal control. As with any internal control, efforts should be made by internal audit to periodically test the design and operating effectiveness of the organization's FCPA compliance policies. For example, CPA firm Amper, Politziner & Mattia, LLP recommends that internal audit integrate an FCPA focus into its regular audits (see <http://www.amper.com/publications/fcpa-audit-screening.asp>).

Report. Fourth, if an FCPA violation is detected, companies should consider coming forward and notifying the authorities. Says Mark Mendelsohn of the DOJ, "If we call them before they call us, it's not where they want to be."¹⁹ To promote disclosure, some companies have set up in-house whistleblowing rewards to ensure compliance or detection of problems. For instance, RAE Systems Inc. paid a total of \$190,000 in bonuses to employees who helped with the company's FCPA investigation into corrupt payments in China.²⁰ The employees also



**THE RISK
PROFILE CAN BE
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helped to create new FCPA compliance policies.

Other resources

Exhibit 1 presents selected FCPA and anti-bribery resources that may be helpful to internal auditors, including regulatory documents, articles, and reports. FCPA issues have been underemphasized for years, but current enforcement activity trends indicate a clear need to understand the provisions of the law and to mitigate FCPA compliance risks. Internal auditors and audit committees can be proactive in their approach to the FCPA by educating company personnel, profiling risk areas, developing compliance policies, and reporting problems early. ■

NOTES

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- ³ Stier, K. 2010. U.S. Cashes in on Corporate Corruption Overseas. *Time* (April 7), <http://www.time.com/time/business/article/0,8599,1977526-1,00.html> (accessed October 15, 2010).
- ⁴ The FCPA Blog, <http://www.fcpcblogger.com/blog/2010/4/19/longest-fcpa-prison-sentence.html> (accessed October 15, 2010).
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- ⁶ Nature's Sunshine Products Inc. Delisted. 2006. *Daily Herald* (April 4), http://www.heraldextra.com/business/article_714a05f6-9bda-57a8-bb2af7e2e7fd5fcd.html (accessed October 15, 2010).
- ⁷ U.S. Securities and Exchange Commission, <http://www.sec.gov/litigation/lit/releases/2009/lr21162.htm> (accessed October 15, 2010).

- ⁸ U.S. Securities and Exchange Commission, <http://www.sec.gov/litigation/complaints/2009/comp21162.pdf> (accessed October 15, 2010).
- ⁹ U.S. Department of Justice, Foreign Corrupt Practices Act, <http://www.justice.gov/criminal/fraud/fcpa/docs/lay-persons-guide.pdf> (accessed October 26, 2010).
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- ¹¹ U.S. Department of Justice, <http://www.justice.gov/opa/pr/2010/January/10-crm-048.html> (accessed October 18, 2010).
- ¹² Rothfeld, M. 2010. Drug Firms Face Bribery Probe. *The Wall Street Journal* (October 5), <http://online.wsj.com/article/SB10001424052748704847104575532091781199092.html> (accessed October 26, 2010).
- ¹³ Ernst & Young. 2008. Corruption or Compliance—Weighing the Costs: 10th Global Fraud Survey, http://info.worldbank.org/etools/antic/docs/Resources/Corruption_or_compliance_weighing_the_costs.pdf (accessed October 26, 2010).
- ¹⁴ Scannell, K. and T. Catan. 2010. Settlements Near in Bribery Case, *The Wall Street Journal* (October 15): A1-A2.
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- ¹⁶ U.S. Department of Justice. 2008. Opinion Procedure Release, <http://www.justice.gov/criminal/fraud/fcpa/opinion/2008/0802.pdf> (accessed October 26, 2010), also see www.skadden.com/content/Publications/DOJ.pdf (accessed October 26, 2010) for a discussion of the implications of Release 08-02.
- ¹⁷ An Effective FCPA Compliance Program—Thoughts of Lanny Breuer, <http://www.lexisnexis.com/Community/corpsec/blogs/corporateandsecuritieslawblog/archive/2010/06/03/an-effective-fcpa-compliance-program-thoughts-of-lanny-breuer.aspx> (accessed October 26, 2010).
- ¹⁸ Greenebaum. 2008. Best Practices For Mitigating FCPA Risk, <https://greenebaum.encryptedssl.com/files/Uploads/Documents/RLBBestPractices.pdf> (accessed October 26, 2010).
- ¹⁹ Searcy, D. 2009. U.S. Cracks Down on Corporate Bribes. *The Wall Street Journal* (May 26), <http://online.wsj.com/article/SB10001424052748704847104575532091781199092.html> (accessed October 26, 2010).
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