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FCPA Prosecutions

The Critical Role of the Accounting and Recordkeeping Provisions

By Stuart H. Deming

As part of the expanding enforcement of the FCPA, the Justice Department and SEC are increasingly using the FCPA's internal controls and recordkeeping provisions to prosecute improper payments that may otherwise be beyond the reach of the antibribery provisions.

Often overlooked in the dramatic increase in enforcement of the Foreign Corrupt Practices Act (FCPA) is the critical role of the FCPA's accounting and recordkeeping provisions. One of the lesser-known problems disclosed by the revelations of the Watergate era in the United States was the accounting and recordkeeping practices that made improper payments possible. To address these practices, in addition to prohibiting improper inducements to foreign officials, the FCPA placed new and significant obligations on issuers to make and keep accurate records and to maintain a system of internal accounting controls.

Known as the "accounting and recordkeeping" provisions, these new obligations constituted the second and less-well-known mechanism to deter improper inducements to foreign officials. Compared to the antibribery provisions, which prohibit improper inducements to foreign officials, the accounting and recordkeeping provisions, in many respects, constitute a more potent mechanism in deterring improper inducements to foreign officials. They provide a completely independent basis for prosecuting issuers or those acting on their behalf for making improper inducements.

Unlike the antibribery provisions, which apply only to improper inducements to foreign officials, the accounting and recordkeeping provisions apply to an issuer's domestic and foreign operations, including domestic reporting and disclosure practices as well as practices involving foreign payments. They create affirmative duties on the part of issuers and officers, directors, employees, agents, and stockholders acting on behalf of an issuer.

As opposed to the antibribery provisions, no proof of intent is required to establish a civil violation under the accounting and recordkeeping provisions. A criminal violation can lead to a 20-year term of imprisonment instead of a five-year term under the antibribery provisions. Moreover, critical evidence of a violation of the accounting and recordkeeping provisions in a foreign setting is more likely to be under the control of an issuer and subject to compulsion by U.S. enforcement authorities.

Broad Reach

Seemingly, the application of the accounting and recordkeeping provisions is more limited than the antibribery provisions. They apply to foreign and domestic issuers of securities as defined by section 3 of the Securities Exchange Act of 1934 (Exchange Act) as entities required to register under section 12 or file reports under section 15(d). Issuers can include foreign entities with American depository receipts (ADRs).

Unlike the antibribery provisions, the accounting and recordkeeping provisions extend to majority-owned foreign subsidiaries of an issuer. In addition, for an issuer to be held civilly liable, it makes no difference whether the controlling entity lacks knowledge of the conduct of the subsidiary that serves as a basis for a violation. Criminal liability may be established where an individual or entity subject to the accounting and recordkeeping provisions knowingly circumvents or fails to implement a system of internal controls or knowingly falsifies any book, record, or account.

Even when an issuer holds an interest of 50 percent or less, the FCPA requires it to "proceed in good faith to use its influence to the extent reasonable under the circumstances to cause [the subsidiary] to devise and maintain a system of internal accounting controls" consistent with the accounting and recordkeeping provisions. In such circumstances, an issuer will be "conclusively presumed" to have complied when it can demonstrate its good-faith efforts to influence its subsidiary. An issuer's duty to influence a subsidiary's behavior increases directly with the degree to which it can exercise control over the subsidiary.

In terms of individuals, while acting within the scope of their duties on behalf of an issuer, individuals, and, in particular, officers, directors, employees, stockholders, and agents of an issuer, can be subject to the terms of the accounting and recordkeeping provisions. The accounting and recordkeeping provisions also extend to individuals who, while acting within the scope of their duties, are officers, directors, employees, or agents of a foreign subsidiary where the issuer has an interest greater than 50 percent.

Except for violations relating to disclosures to auditors, the recordkeeping provisions apply to "any person" and not just to officers and directors. Though proof

As part of the United Nations Food for Oil investigations involving Fiat and York International, the recordkeeping provisions were used as the basis for charging foreign subsidiaries for improper payments to foreign officials. In each instance, the subsidiaries were subject to accounting and recordkeeping provisions but not the antibribery provisions. And, in each instance, an inaccurate description formed the underlying basis for the charges. "Kickbacks" were incorrectly recorded as a "commission," "service fee," or "consultancy payment."

of intent may be required to establish civil liability for aiding and abetting a violation of the accounting and recordkeeping provisions, even individuals and entities not otherwise subject to their terms can become subject to liability. For example, a supplier to an issuer who knowingly facilitates the making of a false invoice to conceal the true nature of the underlying transaction could be subject to prosecution for violating the recordkeeping provisions.

Falsification of Books and Records

Under the recordkeeping provisions, an issuer must ensure that the books and records are accurate so that the financial statements can be prepared in conformity with accepted methods of recording economic events. The recordkeeping provisions are not focused solely with the preparation of financial statements. They seek to strengthen the accuracy of the corporate books and records and the reliability of the audit process. Books and records subject to the recordkeeping provisions are not specifically defined by the FCPA. But given the Sarbanes-Oxley Act of 2002's (Sarbanes-Oxley) emphasis on internal controls and deterring conduct that might impede or affect the audit function, Congress implicitly reaffirmed the broad scope of records subject to the terms of the accounting and recordkeeping provisions.

In general, the greater the degree to which a record may relate to the preparation of financial statements, the adequacy of internal controls, or the performance of audits, the more courts are likely to find the record to be subject to the terms of the recordkeeping provisions. Records such as corporate minutes, transactional documents, and authorizations for expenditures are all incidental to the preparation of financial statements or recording economic events. Records that may relate to internal controls, such as compliance programs, fall within the scope of records subject to the recordkeeping provisions since such records bear on the accuracy of the financial statements. Similarly, records bearing on the audit of financial statements are likely to be extremely broad in scope.

Of critical significance is the absence of a materiality requirement under the recordkeeping provisions. Even if the amount of a transaction does not affect the bottom line of an issuer in quantitative terms, it may still constitute a violation of the recordkeeping provisions if not accurately recorded. A classic situation is presented by expediting payments, which are permitted under the antibribery provisions but could pose a problem if not accurately recorded.

Manipulating records to mask transactions by characterizing them in some oblique manner or actually falsifying a transaction can implicate an issuer and those individuals involved. Placing a transaction into an abnormal category or burying it in some other way may serve as a basis for a violation. The Securities and Exchange Commission's (SEC) posture has been described as one of zero tolerance for the falsification of records relating to an improper inducement.

One practical consideration in prosecuting violations of the antibribery provisions is the difficulty in securing evidence in a foreign setting. This difficulty is further complicated by the question of whether evidence obtained in a foreign setting will be admissible in a U.S. court. In the context of prosecuting a violation of the recordkeeping provisions, the evidence is more likely to be documentary in nature, to be in the possession or control of an issuer, and to be admissible in court. An issuer is subject to compulsion by U.S. enforcement authorities to produce records, including foreign records, in its custody or control.

Moreover, in a criminal context, proving a violation of the recordkeeping provisions is more straightforward and more likely to succeed than proving a violation of the antibribery provisions. The evidence necessary to establish a criminal violation is much simpler and less apt to confuse a jury. Unlike the antibribery provisions, proving corrupt intent is not required. Nor is there a requirement to prove whether a foreign official was involved or whether a promise, offer, or payment was made to obtain or retain business. In large part, the elements of the offense are limited to whether the record is subject to the recordkeeping provisions, whether the conduct was willful, and whether the record was accurate in reasonable detail. The documentary nature of the evidence makes proving a violation less dependent upon recollections that can be subjective and that can fade over time. Unlike proving a bribe, proving a false statement is likely to be much more clear-cut and less susceptible to differing interpretations.

From the standpoint of a prosecutor, a criminal violation of the recordkeeping provisions has an added strategic advantage because it carries a far more severe penalty than a violation of the antibribery provisions. Given the severity of the criminal penalty for a violation of the accounting and recordkeeping provisions, and a greater ability to prove a violation, a prosecutor has an enhanced ability to negotiate a plea. It also enhances a prosecutor's ability to secure cooperation to provide evidence relative to violations of the accounting and recordkeeping provisions as well as the antibribery provisions. Individuals facing a prison sentence are apt to be receptive to alternatives that may limit the possibility of a lengthy prison term.

Material Misrepresentations or Omissions to Auditors

In implementing the recordkeeping provisions through the adoption by the SEC of Rule 13b2-2, officers or directors of an issuer were prohibited from making materially false or misleading statements or omitting to state any material facts in the preparation of filings required by the Exchange Act. Although this rule applies only to officers and directors, and anyone acting on their behalf, it is very broad in terms of its coverage. Under Rule 13b2-2, officers and directors are prohibited from "taking any action to fraudulently influence, coerce, manipulate, or mislead any independent public or certified accountant engaged in the performance of an audit of the financial statements of that issuer for the purpose of rendering such financial statements materially misleading."

Rule 13b2-2 also extends to written and oral statements made to internal auditors as well as to outside auditors by officers or directors. It also extends to "causing another person to make a material misstatement or make or cause to be made a materially false or misleading statement." Not only are misrepresentations covered, but a material omission or failure to clarify a statement so as to make it materially false or misleading can constitute a violation.

Adequate Internal Controls

Under the accounting provisions, the purpose of internal controls is to ensure that issuers adopt accepted methods of recording economic events, protecting assets, and confirming transactions to management's authorization. No specific system of internal controls is required. A system of internal controls must be sufficient to provide reasonable assurance that directors, officers, and shareholders are made aware of and thus able to prevent the improper use of assets. Under the accounting provisions, "[r]easonable assurance" means "such level of detail and degree of assurance as would satisfy prudent officials in the conduct of their own affairs." The standard for compliance is whether a system, taken as a whole, reasonably meets the requirements of the

internal control provisions.

An issuer's antibribery compliance program should not necessarily be separate from its system of internal accounting controls. A natural interplay was intended between the antibribery and the accounting and recordkeeping provisions. An effective system of internal accounting controls includes a range of review and approval guidelines designed to detect and deter questionable payments. Indeed, the planning, implementation, and monitoring of an issuer's compliance program should be closely linked, if not intertwined, with its system of internal accounting controls.

For issuers engaged in international business, the failure to devise or maintain an effective system to prevent or detect violations of the antibribery provisions can constitute a violation of the internal controls provisions. At the very least, it must include a formal FCPA policy made applicable to the entire entity, an FCPA compliance program, and a practice of conducting due diligence and maintaining due diligence records on the entity's foreign agents. Those responsible for ensuring compliance with an FCPA policy must have adequate experience and training to address issues that may arise relative to preventing, detecting, and addressing possible violations of the FCPA.

Due to their esoteric nature, and the absence of specific standards, the internal accounting control provisions are seldom the focus of criminal enforcement activity. Yet, in a civil enforcement context, where no proof of intent is required, these provisions provide an almost endless series of bases for the SEC to take action against an issuer. In almost any after-the-fact analysis relating to financial irregularities, the SEC will be able to point to a breakdown of some sort associated with the internal accounting controls of an issuer.

Expediting Payments

A related consideration is how expediting payments are recorded. An effort to conceal expediting payments by placing them among other types of payments would be improper. Regulators prefer that such expenditures be set out in a separate line item. This reasoning is premised on the view that payments of a questionable nature are not apt to be disclosed. Thus the greater the transparency or degree to which expediting payments are fully disclosed, the less likely they will be perceived as being suspect.

A separate line item may not be required as long as the line item in which an expediting payment is incorporated is both logical and not calculated to conceal. If the expediting payment is a relatively small amount of money and has no relationship to any particular function of an entity, its inclusion in a category of miscellaneous items may not be inappropriate. Similarly, the degree to which the expediting payments may be rolled up into larger line items and thereby hidden is not necessarily improper as long as the manner in which such payments are incorporated into a larger line item is logical and not for the purpose of concealing questionable transactions. The classification is not necessarily false or inaccurate. It is mere circumstance that leads to the expediting payment being, in effect, buried. But should the expediting payment be incorrectly classified so that it may be rolled up into a larger line item and thereby concealed, a basis may exist for a violation of the recordkeeping provisions to be alleged.

Expediting payments also bear on the adequacy of internal controls. Consistent with maintaining an effective compliance program and the heightened obligations on auditors to plan audits so as to detect fraud, issuers need to be in a position to be responsive to inquiries and, if necessary, to quickly identify expediting payments and to provide substantiating documentation. Greater segregation is more likely to enhance the adequacy of internal controls. If the expediting payments are not properly approved, an issuer may also open itself up to possible allegations of inadequate internal controls.

Regardless of whether they may be permitted by the FCPA, the underlying dynamic associated with expediting payments must always be kept in mind. By their very nature, expediting payments are illegal in the country of the intended recipient. Proper recordkeeping is more likely to expose an entity to liability associated with an investigation in the host country for making payments prohibited by local law.

Conclusion

The increased reliance on the accounting and recordkeeping provisions to deter improper payments is not likely to decline. To the contrary, at the core of the heightened obligations under Sarbanes-Oxley are those relating to the FCPA's accounting provisions. Subject to criminal sanctions, internal control reports are now required expressing management's responsibility for establishing and maintaining adequate internal controls for financial reporting and assessing their effectiveness. An attestation by an issuer's outside auditor is also required as to management's assessment of the adequacy of the issuer's internal controls.

In sum, the critical role of the accounting and recordkeeping provisions in deterring improper inducements to foreign officials cannot be overstated. Conduct that may be perceived to be beyond the reach of the antibribery provisions may constitute a violation of the accounting and recordkeeping provisions. Compliance with the FCPA's prohibitions on improper inducements cannot be limited to complying with the antibribery provisions. To be effective, an FCPA compliance program must ensure that adequate internal controls are in place and that accurate recordkeeping practices are rigorously enforced.

In *In re BellSouth Corp*, SEC Exchange Act Release No. 45,279 (Jan. 15, 2002), BellSouth, despite having an interest of less than 50 percent in its Nicaraguan subsidiary, was found to have operational control and an ability to cause the subsidiary to devise and maintain a system of internal accounting controls to detect and prevent FCPA violations. Apart from the Nicaraguan subsidiary, BellSouth's internal controls also were found to be deficient since the attorney responsible for reviewing FCPA issues "lacked sufficient experience or training."

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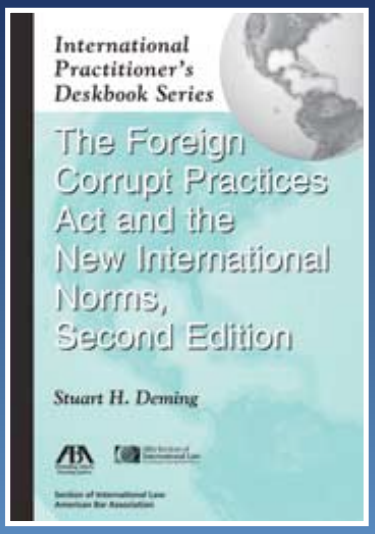
The Foreign Corrupt Practices Act and New International Norms, Second Edition

By Stuart H. Deming



This article is adapted from a chapter of Mr. Deming's best-selling book *The Foreign Corrupt Practices Act and the New International Norms* (ABA Publishing, 2d ed. 2010). For many years, he co-chaired the ABA's National Institutes on the Foreign Corrupt Practices Act; he founded the ABA's Task Force on International Standards for Corrupt Practices, and he is a member of the Board of Editorial Advisors to the *Foreign Corrupt Practices Act Reporter*.

Practitioners, corporate counsel, compliance officials, accountants, and anyone engaged in international business will find *The Foreign Corrupt Practices Act and the New International Norms* to be indispensable in providing a clear and easy-to-read analysis of the Foreign Corrupt Practices Act as well as an extensive compilation of source materials and key documents for addressing matters associated with the FCPA and similar legal regimes being implemented in much of the world.

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