

Identifying and Investigating Fraud and Corruption

Robert M. Mattson, Jr.

Craig D. Martin

The Current Enforcement Environment

- 2008 financial crisis--perceived failure of oversight by regulators
 - SEC
 - Madoff tips as early as 2000
 - Allegations of favoritism in insider trading prosecutions
 - Failure to regulate hedge funds, credit default swap abuses
 - FINRA
 - Banking agencies (FRB, OCC, OTS, FDIC)
- Popular anger over “culture of greed”, AIG bonuses, TARP
- Upshot: no politician or agency wants to appear soft on fraud

Current Environment at Most Companies

- Increased pressure to make the numbers
 - Beyond just meeting market estimates—e.g. debt covenants
 - New accounting rules (e.g. fair value) compounds the problem
 - Difficulty in obtaining credit or accessing capital markets make internally generated cash flows more important than ever
- Cost controls, hiring freezes, RIFs, cuts in discretionary spending
- Investment in new personnel focused on revenue producers
 - Legal/Compliance departments having to do more with less

Perfect Storm

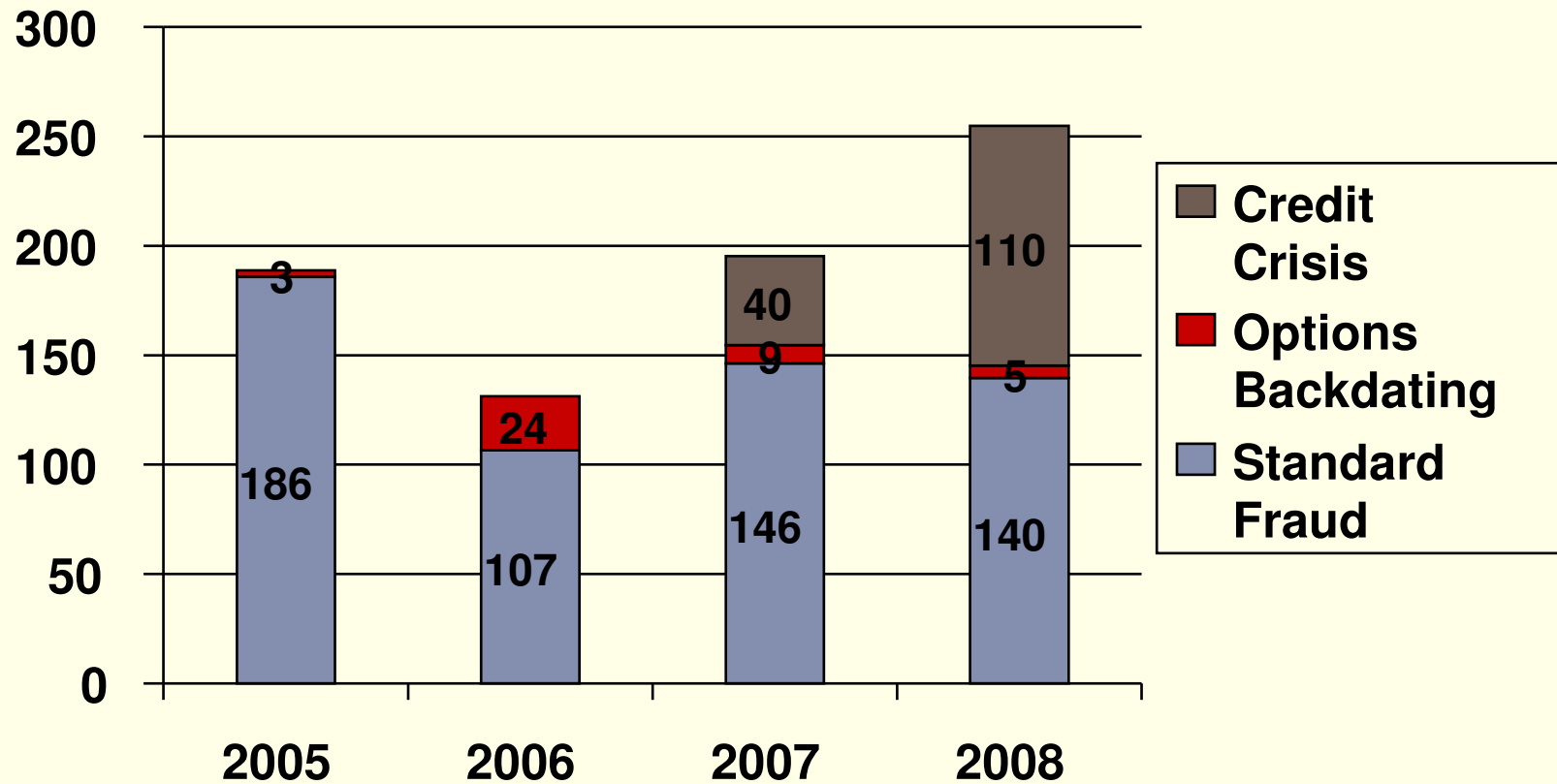
- At a time when defensive regulators and law enforcement authority are under increasing pressure to ferret out wrongdoing and dramatically increase enforcement efforts against entities and individuals, the current economic climate has created increased temptations to skirt the rules to create revenues in any way possible while internal watchdogs are understaffed and underfunded to do their jobs properly

SEC Enforcement 2008

- SEC initiated 671 cases in 2008
 - Up from 656 enforcement actions in 2007
 - But cases settled lowest since passage of Sarbanes Oxley
- Four primary SEC enforcement areas:
 - Insider trading
 - Financial fraud
 - Option Backdating
 - FCPA

Private Securities Litigation 2006-2008

- Nine-year high of 255 civil class action securities fraud cases filed
- New civil cases by type:



Senior Management Doing Hard Time

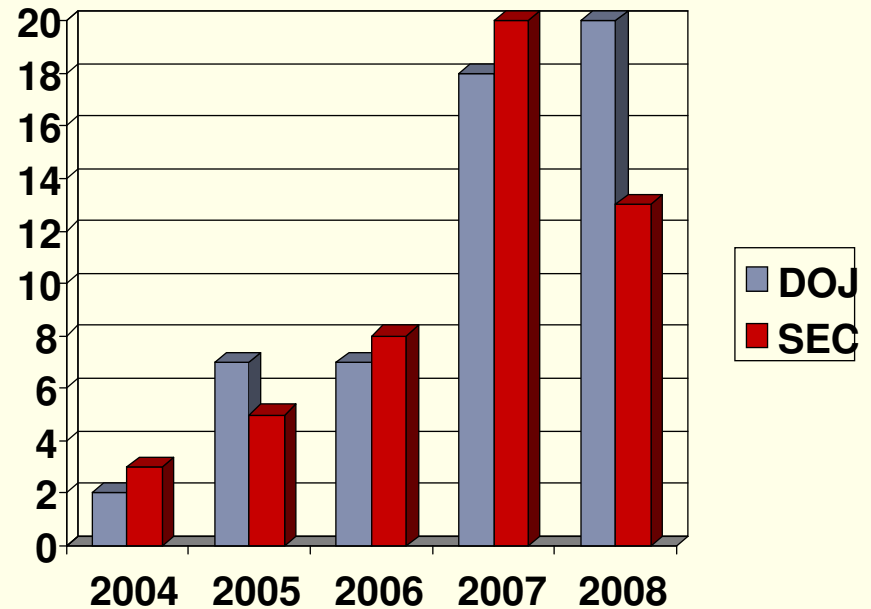
<u>Executive</u>	<u>Company</u>	<u>Sentence</u>
J. Skilling, CEO	Enron	292 months
Joseph Nacchio, CEO	Qwest	6 years
R. Galalis, CFO	Enterasys	11 years
K. Graham, CEO	Thyssen	75 months
S. Wolff, CEO	Homestore	5 years
S. Kumar, CEO	CA	12 years
M. Gabayzedeh, CEO	American Tissue	15 years
J. Rigas, CEO	Adelphia	15 years
P. Bennett, CEO	Refco	16 years
R. Adelson, COO	Impath	42 months
M. Stuart, CEO	Martha Stewart Living	5 months
S. Waksal, CEO	Imclone	7 years
G. Capell, CEO	Computer Video Store	7 years
E. Masferrer, CEO	Hamilton Bancorp	28 months
W. Forbes, Chairman	CUC/Cendant	151 months
G. O'Neal, CEO	Pinnacle Develop.	144 months
P. Quinlan, CEO	MCA Financial	10 years
J. Bricat, CEO	Mercury Finance	10 years

** Restitution/fines in the above case aggregated over \$4.5 billion

FCPA Enforcement 2004-2008

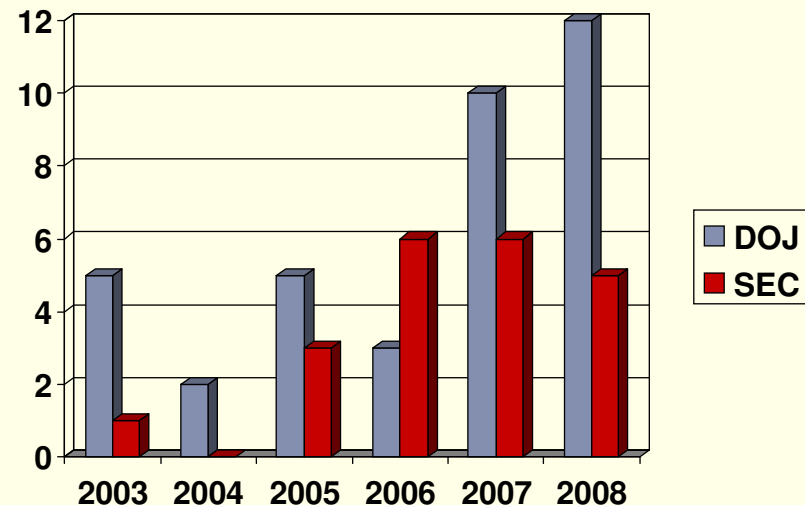
Enforcement Upswing

- 2007 and 2008 saw the two highest yearly number of enforcement actions in SEC and DOJ history
 - 77 DOJ overseas bribery probes under way as of 12/08
- Rising penalties
 - 2008: Siemens, \$450 million (criminal); \$350 million (civil); \$1.6 billion U.S. and Germany
 - 2009: Halliburton/ KBR, \$177 million disgorgement, \$402 million (criminal)



Proceedings against individuals 2003-present

- 2003: 5 DOJ, 1 SEC
- 2004: 2 DOJ
- 2005: 5 DOJ, 3 SEC
- 2006: 3 DOJ, 6 SEC
- 2007: 10 DOJ, 6 SEC
- 2008: 12 DOJ, 5 SEC
- According to SEC officials, the trend will continue in 2009
 - In March '09, six former executives of Control Components indicted for FCPA bribery violations



Focus on FCPA Enforcement

- New SEC Chairperson Mary Schapiro: “FCPA violations have been and will continue to be dealt with severely by SEC and other law enforcement agencies.”
- Trend towards prosecution of individuals to continue in 2009.
- Mark Mendelsohn, deputy chief of the DOJ Fraud section: “[P]ace of prosecution is absolutely certain to continue.” When “needed additional resourced are available . . . The pace of prosecution will take off”
- Procuring financial records from other countries “much easier” and number of multi-jurisdictional cases rising.
- More prosecutions if DOJ gets more funding.
 - Viral prosecutions (e.g. Panalpina)
- More DOJ attorneys dedicated to FCPA full-time.

FCPA Introduction

- Three primary provisions:
 - Anti-bribery
 - Books & records
 - Internal controls
- Applicable to U.S. citizens, firms, certain foreign issuers of securities, certain foreign persons, and firms acting within the U.S.

FCPA Anti-Bribery Provision

Prohibits U.S. person or company from:

- Corruptly paying or offering to pay
- anything of value
- to a foreign official
- directly or indirectly
- To assist in obtaining or retaining business

Use of Intermediaries/ Consultants

- FCPA prohibits payments to any person knowing that all or a portion of the payment will be offered or given to a foreign official
 - Knowledge can be satisfied by “willful blindness”
 - What you don’t know can hurt you
- Company doesn’t need to know that the consultant is paying the government (willful blindness is enough)
- A number of the recent FCPA enforcement actions involve improper payments made on a company’s behalf by an intermediary/consultant/distributor

FCPA's Accounting/Controls Provisions

- Accounting Provision
 - Requirement to make and keep records in reasonable detail to accurately reflect transactions.
- Internal Controls Provision
 - Requirement to devise and maintain a system of internal accounting controls sufficient to provide reasonable assurance that transactions are recorded appropriately and in accordance with rules and regulations.

International Anti-Corruption Law

- Organization for Economic Cooperation and Development Convention
 - Essentially tracks the FCPA
 - Signatories: Argentina, Australia, Austria, Belgium, Brazil, Bulgaria, Canada, Chile, Czech Republic, Denmark, Estonia, Finland, France, Germany, Greece, Hungary, Iceland, Ireland, Italy, Japan, Korea, Luxembourg, Mexico, Netherlands, New Zealand, Norway, Poland, Portugal, Slovak Republic, Slovenia, South Africa, Spain, Sweden, Switzerland, Turkey, U.K., U.S
 - No civil liability component
 - Privacy laws

International Anti-Corruption Law

- EU Public Procurement Directive (2004/18/EC)
 - Mandatory debarment from public procurement if convicted of, among other things, corruption and fraud
- UN Convention Against Corruption
 - 140 signatories, 133 parties
- African Union Convention on Preventing and Combating Corruption
 - 40 signatories, 15 parties
- Inter-American Convention Against Corruption
 - 34 signatories, 33 parties
- Council of Europe Criminal/Civil Law Convention on Corruption
 - 48 signatories, 35 parties
- Asia
 - Japan and Korea are signatories to the OECD

Training

- Train broadly
 - At risk employees, not just management
 - Consultants, agents
- Anti-Corruption Policy
 - Translate
 - Distribute
 - **Employees**
 - **Agents**
 - **Distributors**
 - Remember local law
 - Tone at the top

Training

- Don't rely on "one size fits all" approach
 - Translate your policies into the language of the country
 - Understand the particular cultural customs and norms in the country at issue and modify your communication approach accordingly
- In-person, interactive training is best
 - Give examples
 - Identify in advance the types of entities and individuals who may be considered governmental officials in the country in question
- Get buy-in/input from local country managers
- Foster environment where problems will be surfaced not buried

M&A Due Diligence

- DOJ expects acquirer to undertake anti-bribery due diligence as to target entity
 - Secure protective contractual provisions from acquiree, confirming compliance with applicable anti-bribery laws
 - Red flags
 - Significant business in countries with reputations for corruption
 - Large percentage of business with government customers
 - Notable suspicious entries in target's books and records
- Helpful DOJ FCPA opinions in M&A due diligence context:
 - Release 2003-01
 - Release 2008-01
 - Release 2008-02

M&A Due Diligence: Question to Ask

- In what countries does the target do business
 - Are any a “country of concern” for FCPA purposes?
- Does target use third parties, consultants, agents or distributors?
 - What due diligence has the target done on those third parties?
- What interactions do people at the target have with government officials and government controlled entities?
- What is the reputation of the company, its employees and third party intermediaries?
 - Any prior FCPA/corruption problems?
- How do target’s anti-corruption program and controls stack up against acquiror’s?

Post-Acquisition Integration

- Promptly complete anti-corruption due diligence that was not able to be performed before the acquisition
- Communicate acquiror's policies/code of conduct
 - Retrain as necessary
- Integrate both companies internal accounting controls/systems
- Get clear management ownership over compliance
- Procedures for reviewing and monitoring all third-party relationships
- Periodic internal audits
- Simple and clear whistleblower procedures
- Disciplinary procedures consistently applied

Supervision/Monitoring/Controls

- Know your environment
- Compliance program
 - Board access
 - Resources
 - Credibility (regulators and business)
 - Decentralize?
- Robust controls, audit
 - Payables
 - To third parties?
 - Over-compensated?
 - Petty cash
 - Expense reimbursement

Supervision/Monitoring/Controls

- Have finance and audit personnel closely scrutinize payments related to the following descriptions:
 - Commissions
 - Consulting fees
 - Advertising and promotional expenses
 - Transportation expenses
 - Cost of goods sold
 - Processing fees
 - Miscellaneous expenses
- Don't silo information

Supervision/Monitoring/Controls

- Document Everything
 - Policies
 - Training
 - What was covered
 - Who attended
- Track warranties, certifications
- Keep background checks
 - Track rejected candidates
- Document violations and “near-misses”
 - What happened?
 - Why?
 - Remedial steps

Training and Prevention: Hospitality

- Hospitality Policy:
 - Entertainment
 - Per meal dollar limits?
 - No de minimis exception
 - Best policies address purpose
 - Options
 - Bar all entertain of government officials
 - Permit only when directly related to a promotional event
 - Permit only when approved in advance
 - Annual dollar limits on officials or groups of officials
 - Enforcement
 - Periodic review of T&E reports
 - Petty cash controls
 - Eliminate “advances” or “retainers” to consultants

Training and Prevention: Hospitality

- Hospitality Policy:
 - Gifts
 - Dollar limits?
 - Small items lacking intrinsic value
 - Travel
 - Directly related to promotional event
 - Not lavish
 - No per diem or direct payments
 - Not for official's family, friends
 - Written permission from official's superior
 - No side trips

Handling Facilitating Payments

- Facilitating Payments: payments to expedite routine governmental action, “ordinarily and commonly performed,” that are permitted under written local law
- Options
 - Ban outright
 - Pro: easy to understand and apply policy
 - Con: if practical necessity, policy may be violated and employees may not seek guidance
 - Alternative
 - Tailor policies/procedures to local conditions
 - Decentralize approval process
 - Enhance facilitating payments audits and oversight
- Other considerations
 - Reasonable under the totality of circumstances?
 - No payments before opinion of local counsel that payment is legal

Handling Charitable Contributions

- Philanthropic gifts
 - Due diligence as to any nexus between charity and government official
 - System to detect payments inconsistent with company's general pattern of philanthropy
 - Flag donations that are a disproportionate percentage of philanthropic budget

FCPA Investigations

- Where do cases come from?
 - Self-reporting
 - Mergers and acquisitions
 - Sarbanes Oxley
 - Whistle-blowers
 - Retaliation by employer for internal reporting
 - Retaliation by foreign government officials
 - Data provided by other countries and agencies
 - Proxy statements
 - Parallel securities lawsuits
 - Competitors

Handling an FCPA Investigation

- Key issues
 - Who will oversee the investigation
 - Cross-border data issues
 - Witness interviews
 - Ethical issues
 - Local law
 - Auditors
 - Memorialize results
 - Self-reporting

Self-reporting—increasing trend

- No legal obligation
- Recent trend towards “non-prosecution” and/or “deferred prosecution” agreements following voluntarily disclosure and cooperation with DOJ investigation
 - Siemens: agreement allowed company to continue bidding on American contracts
- Lower likelihood of civil fine if self-report to DOJ
- DOJ opinion procedure
 - Request non-action relief
 - Limited safe harbor to conduct post-acquisition FCPA where acquirer promise to undertake certain “best practices” and disclosure to DOJ

Remedial Measures

- DOJ/SEC more lenient where policies in place
 - Public, compliance-oriented tone at the top
 - Specific policies and frequent training
 - Accurate books and records
 - Oversight and testing
 - Due diligence
- Report potential violations to the company's auditors
 - Even if problem has been corrected and no report to the DOJ or SEC will be made