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SEC's First FCPA Settlement of 2010 Provides Important Reminders for FCPA Compliance

On January 11, 2010, the SEC announced its first Foreign Corrupt Practices Act (FCPA) enforcement filing of 2010. The case serves as an important reminder regarding three fundamental principles of FCPA compliance: *First*, that even when a questionable foreign payment cannot be proven as a corrupt bribe, it can nevertheless result in FCPA liability if it is mischaracterized in the paying company's accounting books and records; *second*, that a parent company can essentially be held strictly liable for the FCPA books-and-records violations of its wholly-owned subsidiaries; and *third*, that prompt internal investigation, self-disclosure, and remediation of a suspected FCPA issue can dramatically reduce the monetary penalty a company will ultimately be required to pay in a subsequent enforcement action.

The SEC's case was filed against NATCO Group Inc. (NATCO), a Houston-based company that provides products and services to the oil and gas industry. In an administrative cease-and-desist order and a contemporaneously filed civil complaint filed in the United States District Court for the Southern District of Texas, the SEC alleged that NATCO's wholly-owned subsidiary, TEST Automation & Controls, Inc. (TEST), "created and accepted false documents while paying extorted immigration fines and obtaining immigration visas in the Republic of Kazakhstan." The SEC further alleged that NATCO's "system of internal accounting controls failed to ensure that TEST recorded the true purpose of the payments, and NATCO's consolidated books and records did not accurately reflect these payments." In settling the case without admitting or denying the SEC's allegations, NATCO agreed to pay a \$65,000 civil penalty and consented to the SEC's cease-and-desist order.

The FCPA is generally known to prohibit bribery of foreign officials, but it also requires U.S. public companies to maintain accurate books and records and effective internal accounting controls. According to the SEC's order and complaint against NATCO, Kazakhstan immigration prosecutors conducted audits of TEST operations in that country in February 2007 and September 2007, and claimed that TEST expatriate employees lacked proper

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immigration documentation. The prosecutors threatened to fine, jail, or deport the workers if TEST did not pay cash fines. The SEC noted that “TEST employees believed the prosecutor’s threats to be genuine,” and that senior managers at TEST’s Louisiana headquarters authorized the payments. Using their personal funds, TEST employees paid the Kazakh officials \$25,000 in February 2007 and \$20,000 in September 2007. TEST reimbursed employees for these payments, but inaccurately recorded the transactions in the company’s books and records as a “salary advance” and “visa fines.”

The SEC further alleged that, in order to obtain immigration documentation for its expatriate employees, TEST often used consultants. One consultant maintained close ties to the Kazakh Ministry of Labor and, on two occasions, requested cash from TEST to assist him in procuring visas. In order to facilitate the cash withdrawal from TEST accounts, the consultant provided TEST with “bogus invoices for ‘cable’ from third-party entities that he controlled.” Ultimately, TEST paid \$80,000 in false invoices, “despite knowing the invoices mischaracterized the true purpose of the services rendered.” As a result of these false invoices, the company’s accounting records did not accurately reflect the true purpose of these payments.

As explained by the SEC, NATCO first discovered potential issues involving payments at TEST during a routine internal audit in late 2007. In response, the company initiated an internal investigation that identified problems with TEST’s business activities in Kazakhstan, including cash payments to Kazakh prosecutors and consultants that were inaccurately recorded in TEST’s accounting records. As a result of these findings, NATCO voluntarily expanded its internal investigation to other geographic regions with historic FCPA concerns, but uncovered no additional issues. At the conclusion of its internal investigation, NATCO voluntarily self-reported its findings to the SEC.

The NATCO settlement provides several important reminders for companies subject to the FCPA. First, it confirms that even when problematic foreign payments are not chargeable under the anti-bribery provisions of the FCPA—here because some of the payments apparently were motivated by a genuine perception of extortionate threats rather than by corrupt intent, while others apparently could not be traced to recipients who were “foreign officials”—they can still result in liability under the FCPA’s books-and-records provisions if the paying company mischaracterizes the payments in its supporting documentation and accounting records. Thus, companies should exercise extreme caution before making payments to foreign officials even when motivated by understandable and non-corrupt intentions such as in response to extortionate threats. Additionally, employees should be wary of any payment whose intended beneficiary cannot be determined. In any event, companies should ensure that all employees (including employees of subsidiaries) understand that entries in the company’s accounting books and records must be transparent and accurate regardless of the circumstances.

Second, the NATCO settlement continues a trend seen in previous FCPA cases in which parent companies have been held responsible for the FCPA books-and-records violations of their wholly-owned subsidiaries, even where the parent company had no knowledge of the improper conduct. Although the SEC’s charging documents indicate that personnel of NATCO, the parent company, had no direct involvement in or knowledge of the misconduct committed by employees of its TEST subsidiary, the parent company was nevertheless held liable for the resulting accounting violations committed by TEST employees. Therefore,



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parent companies should maintain effective accounting and compliance systems to ensure that all financial transactions are recorded accurately and properly at all levels of the company. Likewise, companies would be prudent to establish procedures to ensure that FCPA and related anti-corruption policies and procedures are implemented and adhered to in all subsidiaries. In essence, companies should expect the SEC and the Department of Justice to take the position that the parent company effectively “owns” the FCPA books-and-records problems of its wholly-owned subsidiaries.

Third, the NATCO matter is notable for the relatively small civil penalty agreed upon as part of the settlement. The SEC appears to have given the company substantial credit for its cooperation and remedial efforts. In addition to conducting an extensive internal investigation (including voluntary expansion of the investigation to other “high-risk” countries) and self-reporting the results of its investigation to U.S. authorities, NATCO implemented numerous remedial measures, including: employee termination and disciplinary actions; revising form documents for agent agreements; establishing new due diligence procedures for vetting and retaining third-party intermediaries; increasing staffing in its global compliance department (including the appointment of a full-time Chief Compliance Officer); improving its FCPA compliance training programs globally; and restructuring its internal audit function and enhancing its monitoring and audit process as part of the compliance program.

Finally, we note two more recent developments that further highlight the increasing importance of cooperation, remediation, and FCPA compliance in general. First, just days after filing its NATCO case, the SEC announced significant new incentives for companies and individuals to make similar voluntary disclosures and to cooperate in its investigations. (See www.kslaw.com/Library/publication/ca011510.pdf). Then, on January 22, the U.S. Department of Justice announced the arrest and indictment of 22 individuals caught in “the first large-scale use of undercover law enforcement techniques to uncover FCPA violations.” According to the DOJ press release, an undercover FBI agent posing as a “sales agent” solicited “commissions” to be shared with the fictional defense minister of an unspecified African country, and employees of several companies in the military and law enforcement products industry allegedly took the bait. (See www.justice.gov/opa/pr/2010/January/10-crm-048.html). Given the government’s apparent success with this undercover operation, all companies doing business overseas should candidly assess their level of confidence that their own employees would recognize the impropriety of offering such payments and thereby keep the company out of harm’s way.

[*In the Matter of NATCO Group Inc.*, SEC Adm. Proc. File No. 3-13742 (Jan. 11, 2010); *SEC v. NATCO Group, Inc.*, Civil Action No. 4:10-CV-98 (S.D. Tex. Filed Jan. 11, 2010). SEC Litig. Rel. No. 21374 (Jan. 11, 2010)]

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