

Foreign Corrupt Practices Act | August 11, 2009

SEC Charges Executives with Control Person Liability Based on Corporation's FCPA Books and Records Violations

In a recent enforcement action, the U.S. Securities & Exchange Commission charged a parent corporation with violating the FCPA's anti-bribery, books and records, and internal controls provisions as well as other securities law violations based on payments allegedly paid by its Brazilian subsidiary to customs brokers to facilitate the importation of unregistered products. Significantly, the SEC also charged two of the company's executives with violating the FCPA's books and records and internal controls provisions based on their position as "control persons," even though the SEC did not allege that the executives had personal knowledge of the payments. Thus, the case may presage a broader enforcement effort against executives who fail to adequately supervise employees responsible for maintaining the company's books and records and system of internal controls.

Background

On July 31, 2009, the SEC filed a settled enforcement action against Nature's Sunshine Products, Inc. (NSP); Douglas Faggioli, a current NSP executive; and Craig D. Huff, a former NSP executive. The complaint alleged that NSP violated the FCPA's anti-bribery, books and records, and internal controls provisions. The SEC further alleged violations of the antifraud and issuer reporting provisions of the federal securities laws. The SEC also charged Faggioli and Huff with violating the FCPA's books and records and internal controls provisions as "control persons" within the meaning of Section 20 of the Securities Exchange Act of 1934 (15 U.S.C. § 78t(a)). Without admitting or denying the allegations, all three defendants agreed to orders enjoining them from future violations and requiring NSP to pay a civil penalty of \$600,000 and Faggioli and Huff to each pay a civil penalty of \$25,000.

NSP is a manufacturer of nutritional and personal care products. In 1994, it established a wholly-owned subsidiary in Brazil, Natures Sunshine Produtos Naturais Ltda. (NSP Brazil). Soon thereafter, Brazil became NSP's largest foreign market. In 1999 and 2000, the Brazilian government reclassified specified vitamins, herbal products, and nutritional supplements as medicines, which required companies selling those products to register them for importation and sale in Brazil. NSP Brazil was unable to register some of its products and, as a consequence, the sales for NSP Brazil declined sharply from approximately \$22 million in 2000 to approximately \$2.6 million in 2003.

In an effort to circumvent the new registration requirements, NSP Brazil allegedly made over \$1 million in undocumented cash payments to customs brokers. Some of these cash payments, which were typically booked by NSP Brazil as "importation advances," were

later paid to customs officials to allow NSP to import unregistered products.

The SEC's allegations focus on the alleged falsification of NSP's books and the failure of NSP executives to adequately supervise NSP employees responsible for maintaining accurate books and records and internal controls. The SEC alleges a number of facts suggesting that members of senior management were informed, or should have known, about the registration problems in Brazil. Specifically, the complaint alleges that two former NSP controllers, one of whom was a corporate officer and NSP's corporate controller, visited the offices of NSP Brazil in December 2000. The NSP controllers interviewed NSP Brazil's operations manager, who allegedly expressed his concern that NSP Brazil did not have the proper product registration for many NSP products imported into Brazil; that NSP Brazil had to pay customs brokers approximately 25% of the value of the products to handle the importation of the unregistered products; and that the unregistered products were being sold illegally in Brazil. The operations manager allegedly also told the NSP controllers that he had complained about these issues to NSP Brazil's general manager but was informed that NSP was aware of the problems. According to the SEC's complaint, the NSP controllers who conducted interviews in Brazil had responsibility for maintaining NSP's books and records and preparing NSP's financial statements regarding the inclusion of financial information for NSP's foreign subsidiaries, including NSP Brazil. One of the former NSP controllers also claimed to have informed a senior manager about the interviews.

In November 2001, NSP Brazil hired a new controller who allegedly discovered approximately 80 cash payments for which there was no supporting documentation. These cash payments included the payments to the customs brokers. Nevertheless, NSP accounted for the payments in their 2001 financial statements as if they were legitimate importation expenses. In 2002, NSP Brazil allegedly purchased false supporting documentation for the improper customs payments.

In March 2002, NSP filed its 2001 10-K with the SEC, in which it noted that NSP Brazil had experienced a decline in sales "due to import regulations imposed by the Brazilian government." NSP failed to disclose any information related to the improper customs payments in this filing.

Control Person Liability

The charges against Faggioli and Huff are noteworthy because they are based solely on control person liability, which has rarely (if ever) been used by the SEC in FCPA cases. Even more surprising is that the SEC's allegations are based on a "failure to supervise" theory, and the SEC does not allege that either of these executives participated in or knew of the violations.

The SEC's complaint charged Faggioli and Huff with control person liability for NSP's primary violation of the FCPA's books and records and internal controls provisions. Under Section 13(b)(2)(A) of the Exchange Act (15 U.S.C. § 78m(b)(2)(A)), an issuer is required to "make and keep books, records, and accounts, which in reasonable detail, accurately and fairly reflect the transactions and dispositions" of the issuer's assets. Section 13(b)(2)(B) of the Exchange Act (15 U.S.C. § 78m(b)(2)(B)) requires issuers to devise and maintain a system of internal accounting controls sufficient to provide reasonable assurances that books and records are accurate and that transactions are taken pursuant to management direction. In civil cases, these provisions impose strict liability on issuers, but are usually read to require *scienter* for individuals, *i.e.*, requiring that individuals knowingly evaded or failed to implement internal controls or falsified books and records.

The SEC brought charges against Faggioli and Huff based on their status as control persons. The control person liability provision of the Exchange Act, Section 20(a) (15 U.S.C. § 78t(a)), provides that: "Every person who, directly or indirectly, controls any person liable under any provision of this chapter or 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.”

To support its control person theory in *Nature's Sunshine Products*, the SEC stated that Faggioli, NSP's current CEO, was the COO of NSP and a member of its Board of Directors during 2000 and 2001, a position which gave him supervisory responsibilities for the senior management and policies regarding the worldwide manufacture, inventory, and distribution of NSP's products. Thus, Faggioli was responsible for supervising the export and sales of NSP's products. The SEC further noted that the President of NSP International and “other senior management who were directly or indirectly responsible for the management and policies related to the manufacture, inventory and distribution of NSP world-wide” reported directly to Faggioli.

With respect to Huff, who retired from NSP in 2006, the SEC noted that he was NSP's CFO in 2000 and 2001. This position gave him supervisory responsibilities for the senior management and policies regarding the making and keeping of books and records at NSP that would reflect the state of registration of products sold in Brazil and the system of internal controls that would monitor the registration of NSP products sold in Brazil. The SEC stated that senior management responsible for making and keeping NSP's books and records and devising and maintaining NSP's internal controls reported directly to Huff.

Finally, the SEC alleged that Faggioli and Huff failed to adequately supervise NSP personnel in 2000 and 2001 to make and keep books and records accurately reflecting the state of registration of NSP's products in Brazil and to devise and maintain a system of internal controls sufficient to provide assurance that registration of NSP's products was adequately monitored.

Critically, the SEC did not allege that Faggioli or Huff had personal knowledge that certain NSP products were not properly registered in Brazil, that NSP Brazil was making or had made cash payments to customs brokers to

facilitate the importation of these unregistered products, or that the unregistered products were being illegally sold in Brazil. Although the facts alleged in the SEC's complaint imply that senior management should have been aware of the problems in Brazil, the SEC stops short of alleging that Faggioli or Huff were actually made aware of the controllers' findings.

Future Expansion of Control Person Liability?

The SEC may have determined that control person liability was particularly appropriate in this case because, with approximately 1,000 employees, NSP is a relatively small company with a small group of senior managers. Brazil was NSP's largest foreign market, which suffered a precipitous drop in sales from 2000 to 2003 after the Brazilian governmental implemented the new registration requirements; senior management was undoubtedly aware that this sharp decline in sales was related to NSP's inability to meet Brazil's new regulations. Furthermore, there was clear evidence that corporate controllers with access to senior management were informed of the cash payments to customs brokers in December 2000 while the payments were ongoing. Moreover, the NSP Brazil controller hired in November 2001 discovered approximately 80 cash payments in NSP Brazil's books that lacked adequate documentation. Despite the lack of supporting documentation, the payments were included as legitimate expenses in NSP Brazil's books, which were then consolidated into NSP's 2001 financial statements. Thus, there are strong indications that senior management should have been aware of the problems in Brazil. In addition, although neither the SEC's complaint nor the company's release mentions it, the company's previous auditor, KMPG, resigned in March 2006, alleging that Faggioli had “made misrepresentations to KPMG on at least two occasions” and had “approved a payment in violation of the Foreign Corrupt Practice[s] Act.” This, too, may have been a factor in assessing control person liability against Faggioli and Huff.

On the other hand, NSP voluntarily disclosed the problematic conduct to the SEC and DOJ after NSP's

Audit Committee conducted an independent investigation. According to a statement from NSP, the company also fully cooperated with the SEC's and DOJ's investigations. (The DOJ has not, and is not expected to, bring charges against NSP.) NSP has also reviewed its internal controls, implemented new controls and FCPA training for employees, and devoted additional resources to complying with its financial reporting obligations.

While it may prove to be limited to its facts, *Nature's Sunshine Products* signals the SEC's intention to hold executives liable for their company's books and records and internal controls under all available theories. To hold an officer liable for a direct violation of the same provisions, even in an uncontested settlement, the SEC would necessarily have to allege the officer's involvement in the scheme and intent to defraud. Even a theory that

an officer "aided and abetted" the company's FCPA violations would require actual knowledge and substantial assistance. See 15 U.S.C. § 78t(e). In light of these well accepted thresholds for individual responsibility under the FCPA, the SEC's decision to charge Faggioli and Huff with control person liability without alleging that either of them participated in or had personal knowledge of the FCPA violations raises the disturbing spectre of *strict liability* for executives. At a minimum, the SEC's embrace of "control person" liability for FCPA violations will shift the burden to officers who choose not to settle to prove that they acted in good faith and did not directly or indirectly induce the acts triggering liability.

This memorandum is intended only as a general discussion of these issues. It should not be regarded as legal advice. We would be pleased to provide additional details or advice about specific situations if desired.

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