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DISCLOSURE

Assessing the Increased Regulatory Focus on Public Company Internal Control and Reporting




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Over the past few months, the Securities and Exchange Commission ("SEC") has publicly stated its increasing focus on public company internal controls and related reporting obligations. In February of this year at the Practicing Law Institute's *SEC Speaks* conference, Ryan Evans from the SEC's Office of the Chief Accountant identified internal controls as an "important issue" and an "ongoing area of focus."[2]

Then, in July, Kara Brockmeyer, who heads the SEC Enforcement Division's FCPA unit, called the Commission's renewed emphasis on internal control reporting "a wake-up call," and noted that companies must do their best to "ensure that the right internal controls are in place and operating."[3] Tellingly, charges brought by the SEC against organizations for violating internal control reporting rules appear to be on the rise. Likewise, the Financial Industry Regulatory Authority ("FINRA") and the U.S. Treasury Department have shown an increased interest in this area as well.

This article discusses recent regulatory activity in this area and the implications for public companies in dealing with enhanced scrutiny of internal control systems and reporting. In particular, in addition to the potential for having to pay substantial fines, in certain situations a company's resolution of a matter with the regulator has required replacing management, retaining new outside auditors, retaining an independent consultant to review internal controls and/or creating a department dedicated to internal controls. Obviously, the cost and disruption necessitated by having to implement these

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[2] Edith Orenstein, *Internal Control Reporting an Area of Focus at SEC*, Financial Executives International Financial Reporting Blog (Mar. 3, 2014), http://www.financialexecutives.org/KenticoCMS/FEI_Blogs/Financial-Reporting-Blog/March-2014/Internal-Control-Reporting-An-Area-of-Focus-at-SEC.aspx#axzz3B4Z1tKC1.

[3] Press Release, SEC, SEC Charges Smith & Wesson with FCPA Violations (July 28, 2014), *available at* http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370542384677.

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types of sweeping remedies are substantial. Companies are advised to assess their internal controls on an ongoing basis and voluntarily implement enhancements to the internal control and reporting structure whenever deficiencies are identified or problems arise. Doing so has the potential to avoid making such remedies part of a regulatory settlement, and thereby reduces the risk of later follow-on regulatory action for lack of compliance with the settlement order itself.

Background. The term ''internal controls'' refers to all the procedures and practices instituted by a company to manage risk, conduct business efficiently, protect assets and ensure to the extent practicable that activities are conducted pursuant to relevant laws and company compliance policies.[4] There are three primary categories of internal controls, those governing: (i) operations, (ii) company compliance with laws and regulations, and (iii) financial reporting.[5]

Public companies have expressly been required by statute to establish and maintain internal controls since the enactment of the Foreign Corrupt Practices Act (''FCPA'') in 1977. In particular, the FCPA amended Section 13(b) of the Securities Exchange Act of 1934 (the ''Exchange Act'') to generally require issuers to keep books, records and accounts that accurately reflect the company's transactions and maintain internal accounting controls to ensure that company transactions are recorded in accordance with management's authorization and in conformity with Generally Accepted Accounting Principles (''GAAP'').[6] Many of the SEC's internal control related charges include alleged violations of Section 13(b). The Sarbanes-Oxley Act of 2002 (''Sarbanes-Oxley'') expanded these obligations, requiring companies to assess and report on their internal controls.[7] In particular, Section 404 of Sarbanes-Oxley directed the SEC to adopt rules requiring public company annual reports to contain an internal control report, which would (1) establish management's responsibility for maintaining an adequate internal control structure, and (2) contain a yearly assessment of the effectiveness of the internal control structure as it relates to financial reporting.[8]

For purposes of SEC enforcement activity, internal control over financial reporting (''ICFR'') is probably the most significant aspect of the internal controls architecture. ICFR is meant to facilitate the preparation of accurate financial statements, and thus, the purpose of assessing ICFR is to identify material weaknesses that have ''more than a remote likelihood of leading to a material misstatement in [a company's] financial statements.''[9]

Recently, the SEC has initiated a number of investigations into and levied charges against companies that have a lax internal control structure or inadequate reporting. Similarly, FINRA recently has levied charges against several financial institutions for failure to establish and implement effective anti-money laundering controls.[10] Pursuant to the Bank Secrecy Act, financial institutions are required to develop and maintain what is known as ''an effective anti-money laundering program.''[11] Brokers or dealers in securities registered with the SEC are defined as financial institutions under the Bank Secrecy Act – required, just like banks and the range of non-bank financial institutions (such as, for example, insurance companies and casinos) that fall within that definition, to implement an effective anti-money laundering program.[12] The four essential components of an AML program, known today as the ''Four Pillars,'' include: (1) development of written internal policies, procedures, and controls to provide for anti-money laundering detection and compliance with the Bank Secrecy Act; (2) designation of a compliance officer; (3) an ongoing employee training program; and (4) an independent audit function to test programs.[13] As discussed further in this article, although FINRA has historically taken the lead role in the investigations of broker dealers for anti-money laundering programmatic failures, recent press reports however indicate that the SEC intends to take a much more active role.[14]

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[4] The Committee of Sponsoring Organizations of the Treadway Commission, an independent private sector initiative in the areas of risk management and fraud deterrence, defines an internal control as ''a process, effected by an entity's board of directors, management, and other personnel, designed to provide reasonable assurance regarding the achievement of objectives relating to operations, reporting, and compliance.'' *See* COSO Definition of Internal Control, *available at* http://www.coso2013.com/pages/definition.html.

[5] Kayla J. Gillian, Board Member, Public Company Accounting Oversight Board, Presentation at the Spring Meeting of the Council of Institutional Investors: A Layperson's Guide to Internal Control Over Financial Reporting (ICFR) (Mar. 31, 2006), *available at* http://pcaobus.org/News/Speech/Pages/03312006_GillanCouncilInstitutional Investors.aspx.

[6] *See* 15 U.S.C. § 78m (2014).

[7] 15 U.S.C. § 7262 (2014).

[8] *Id.*

[9] Staff Statement on Management's Report on Internal Control Over Financial Reporting (May 16, 2005), *available at* http://www.sec.gov/info/accountants/stafficreporting.htm. According to the SEC, ICFR was designed to provide a ''reasonable assurance'' regarding the reliability of financial reporting. *See* 17 C.F.R. § 240.13a-15, Rule 13a-15(f) of the Exchange Act.

[10] While this article focuses on SEC and FINRA enforcement, private civil actions also recently have been filed against corporations in connection with internal control deficiencies. Such actions are likely to become more prevalent along with increased regulatory activity. *See, e.g.*, *Hotel Trades Council and Hotel Ass'n of New York City, Inc. Pension Fund*, No. 13-cv-246 (N.D. Ga. Jan. 23, 2013) (shareholder derivative action alleging that board of directors and two senior officers failed to ensure that there were sufficient internal controls to maintain the accuracy of financial reports and ensure the company's disclosures to shareholders were truthful and accurate); *Provident Wealth Advisors v. John Hancock Life Ins. Co.*, No. 13-cv-11143 (D. Ma. May 8, 2013) (sub-agents of a life insurance company alleged negligence against employer for failing to pay commissions as a result of the life insurance company's lack of internal controls); *Xie v. Hospira Inc.*, No. 10-cv-06777 (N.D. Ill. Oct. 21, 2010) (wrongful termination suit based on ex-employee's termination of employment following his report of internal controls violations to his manager).

[11] 31 U.S.C. § 5318(h).

[12] 31 U.S.C. § 5312(a)(2)(G); 31 C.F.R. § 1023.210.

[13] 31 U.S.C. § 5318(h).

[14] *See* ''SEC's Tougher Enforcement Tack Will Mean Additional AML Penalties: Advisors,'' *Moneylaundering.com*, Oct. 13, 2013, *available at* http://www.moneylaundering.com/News/Pages/128250.aspx; *see also* Mary Jo White, Chair, SEC, ''Remarks at the Securities Enforcement Forum'' (Oct. 9, 2013), *available at* http://www.sec.gov/News/Speech/Detail/Speech/1370539872100#.U_KGTmNjsVo.

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Matters Involving Internal Control Deficiencies. Earlier this year, the SEC settled accounting fraud charges against the former CFO of DGSE Companies Inc.,[15] a company specializing in the purchase and sale of jewelry, diamonds, fine watches and other collectibles. The SEC alleged that DGSE's CFO repeatedly made false accounting entries that materially inflated by more than 99% the value of inventory on the balance sheets. The SEC also concluded that deficiencies in DGSE's accounting systems and internal controls ''led to problems that significantly compromised the integrity of the company's financial data.''[16] In particular, the SEC charged that DGSE had ''antiquated accounting systems,'' and that its internal controls department was not sufficiently staffed.[17] The charges against DGSE were settled in May, with the company's CFO agreeing to pay a $75,000 penalty and DGSE agreeing to remedy its internal controls deficiencies and appoint an independent consultant to review the company's accounting controls.[18] The internal controls-related measures taken by DGSE included replacing all members of the prior management team, hiring new independent auditors, instituting a regular blind inventory check that would be independently reconciled by a newly-formed internal controls department, and reinforcing the company's Code of Business Conduct & Ethics.[19]

Last year, the SEC also targeted PACCAR, Inc., a commercial truck manufacturer, for three distinct financial reporting errors that the Commission traced to deficiencies in the company's internal controls.[20] The SEC alleged that PACCAR (1) failed to report the operating results for its parts business as a reportable segment as required by GAAP, (2) failed to maintain accurate books and records regarding its impaired loans and leases, and (3) overstated the amount of retail loans and lease originations, and collections for two foreign subsidiaries in its statement of cash flows.[21] Each of these financial reporting errors, according to the SEC, was caused by PACCAR's inadequate internal accounting controls. The charges against PACCAR were resolved with the company consenting to the entry of a permanent injunction prohibiting future violations of the securities laws and paying a $225,000 penalty. The SEC also announced that the settlement took into account PACCAR's implementation of remedial measures to enhance its internal accounting controls and compliance with GAAP.[22]

On September 11, 2014, the SEC brought charges against Wilmington Trust Company (''Wilmington'') for fraud and violations of the internal controls provisions of the federal securities laws.[23] The SEC alleged that during 2009 and 2010, Wilmington failed to report the accurate amount of loans on its balance sheet that were at least 90 days past due. The SEC also contended that Wilmington's ''deficient internal controls prevented timely consideration of the effect of the [past due loans] on the Bank's reserve.''[24] To resolve the claims, Wilmington consented to the entry of an order finding that it violated various provisions of the securities laws (including the provisions related to internal controls), paid an $18.5 million penalty and agreed to cease and desist from committing or causing any violations and any future violations of the provisions in question.

DGSE, PACCAR and Wilmington are just a few prominent examples of the SEC's determination to target internal control deficiencies, but there are many others.[25] As Michael Dicke, an SEC Associate Regional Director, observed in connection with the PACCAR case, ''[c]ompanies must continually and diligently monitor their internal accounting systems to ensure that the information they are providing investors is accurate and consistent with relevant accounting guidance.''[26]

''Management Assessment'' and Certification. In addition to the FCPA requirements that a company ''devise and maintain'' sufficient internal controls to prevent the bribery of foreign government officials to win or maintain business, Sarbanes-Oxley obliges management annually to submit a report on ICFR. In doing so, the CEO and CFO must certify that they have reviewed the annual report, determined its accuracy, and disclosed any significant deficiencies in ICFR to the company's outside auditors.[27] The SEC's emphasis on management assessment and certification stems from its stated view that deficiencies in ICFR could lead to incorrect or fraudulent accounting entries in a company's books and records.

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[15] *SEC v. DGSE Cos. Inc.*, No. 14-cv-1909 (N.D. Tex. May 27, 2014).

[16] *SEC v. DGSE Cos. Inc.*, SEC Litigation Release No. 23003 (May 27, 2014), *available at* http://www.sec.gov/litigation/litreleases/2014/lr23003.htm.

[17] *See* Complaint, *SEC v. DGSE Cos. Inc.*, No. 14-cv-1909, *available at* http://www.sec.gov/litigation/complaints/ 2014/comp-pr2014-106.pdf.

[18] *SEC v. DGSE Cos. Inc.*, SEC Litigation Release No. 23003 (May 27, 2014), *available at* http://www.sec.gov/litigation/litreleases/2014/lr23003.htm.

[19] *See* Complaint, *SEC v. DGSE Cos. Inc.*, No. 14-cv-1909, *available at* http://www.sec.gov/litigation/complaints/ 2014/comp-pr2014-106.pdf.

[20] *See SEC v. PACCAR Inc.*, No. 13-cv-953 (W.D. Wash. June 3, 2013).

[21] *See SEC v. PACCAR Inc.*, SEC Litigation Release No. 22711 (June 3, 2013), *available at* http://www.sec.gov/litigation/litreleases/2013/lr22711.htm.

[22] *Id.*

[23] Press Release, SEC, SEC Charges Bank Holding Company in Delaware with Improper Accounting and Disclosure of Past Due Loans (Sept. 11, 2014), *available at* http://www.sec.gov/News/PressRelease/Detail/ PressRelease/1370542911779.

[24] *In re Wilmington Trust Corp.*, SEC Admin. Proc. File No. 3-16098, Securities Act Release No. 9646, Exchange Act Release No. 73076 (Sept. 11, 2014), *available at* http://www.sec.gov/litigation/admin/2014/33-9646.pdf.

[25] *See e.g.*, *In re Neely*, SEC Admin. Proc. File No. 3-15945, Securities Act Release No. 9605, Exchange Act Release No. 72470 (June 25, 2014), *available at* https://www.sec.gov/litigation/admin/2014/33-9605.pdf; *In re Poti*, SEC Admin. Proc. File No. 3-15651, Exchange Act Release No. 71117 (Dec. 18, 2013), *available at* http://www.sec.gov/litigation/admin/2013/34-71117.pdf; *In re Medifast, Inc.*, SEC Admin. Proc. File No. 3-15502, Exchange Act Release No. 70448 (Sept. 18, 2013) *available at* http://www.sec.gov/litigation/admin/2013/34-70448.pdf; *In re Aesoph*, SEC Admin. Proc. File No. 3-15168, Exchange Act Release No. 68605 (Jan. 9, 2013), *available at* https://www.sec.gov/litigation/admin/2013/34-68605.pdf.

[26] Press Release, SEC, SEC Charges Fortune 200 Company for Accounting Deficiencies (June 3, 2013), *available at* http://www.sec.gov/News/PressRelease/Detail/PressRelease/1365171575142.

[27] *See* 15 U.S.C. § 78m (2014) (Section 13(b)(2) of the Exchange Act).

SEC investigations relating to ''management assessment'' of ICFR typically involve situations in which a company's CEO or CFO is first charged with manipulating inventory, loan details or similar financial information in order to deceive a company's external auditors. Once the executives have been implicated, the SEC will generally also bring internal controls-related charges against the company as well.

In July 2014, for example, the SEC brought internal controls-related charges against the CEO[28] and former CFO[29] of QSGI Inc., a Florida-based computer equipment company. The SEC alleged that (i) QSGI executives verified in the company's annual report that they had assessed the company's internal controls and (ii) the certification stated that all significant deficiencies in internal controls had been disclosed to external auditors. According to the SEC, neither of these assertions was true. The SEC contended that the CEO did not participate in the assessment process, and far from keeping company auditors informed about internal controls shortcomings, the executives misled auditors regarding the adequacy of internal controls over inventory in the company's Minnesota operations.[30] Based on the false management report and certification, the SEC charged the two executives with violations of Sections 10(b) and 13(b) of the Exchange Act. One of the executives consented to a cease and desist order finding that he willfully violated sections of the securities laws, and agreed to pay a $23,000 penalty and accept a five-year suspension from practicing as an accountant for a public company. The case against the other executive remains ongoing. As Scott Friestad, an associate director in the SEC's Enforcement Division, recently reiterated in connection with the QSGI settlement, ''[c]orporate executives have an obligation to take the Sarbanes-Oxley disclosure and certification requirements very seriously.''[31]

FCPA Violations. The core of the 1977 FCPA statute is the prohibition against bribery of foreign government officials to gain or keep business. These provisions are complemented by accounting rules that require public companies to maintain an internal control structure that seeks to ensure that company business is transacted in accordance with management's authorization. Although the jurisdictional reach of the FCPA's internal controls provision is more limited than the antibribery provisions, it still applies to all issuers of securities registered under Section 12 of the Exchange Act[32] or that are required to file reports under Section 15(d) of the Exchange Act.[33] These provisions also extend to foreign subsidiary internal controls. Common FCPA-related internal control issues include failure to implement an anti-corruption compliance program, failure to perform third-party due diligence, and failure of internal audit to uncover or prevent misconduct.

Traditionally, the primary focus of FCPA investigations has been the discovery and deterrence of improper payments. In such cases, the SEC generally has forced defendants to disgorge all profits and benefits derived from payments that violate the FCPA. Earlier this year, for instance, Hewlett-Packard Co. (''HP'') agreed to pay $108 million (including disgorgement) to settle FCPA actions by the SEC and the Department of Justice based on bribes allegedly paid to win contracts with the governments of Russia, Poland and Mexico. The SEC also alleged that HP lacked sufficient internal controls to stop the bribery and failed to ensure that the controls were reasonably designed and properly implemented across its entire business operations.[34]

Similarly, the SEC charged Smith & Wesson for failing to implement a system of internal controls reasonably designed to address the increased risks of a new business model (to make sales in new and high risk foreign markets) when senior employees made and authorized improper payments to foreign government officials in an attempt to win contracts to sell firearms to foreign military and law enforcement departments.[35] Specifically, Smith & Wesson allegedly failed to perform any anti-corruption risk assessment, conducted virtually no due diligence of its third party agents, failed to devise adequate policies for commission payments and maintained deficient FCPA-related training and supervision.[36] The company agreed to pay a nearly $2 million penalty. While the SEC did not enforce nonmonetary remedial requirements, the Commission did consider the remedial acts that Smith & Wesson took after the conduct came to light, including halting various international sales transactions and terminating its entire international sales staff.

The SEC's Enforcement Division has recently expanded its formulation of the FCPA's internal controls provision and reach. For example, in August 2012, the SEC charged Oracle with violating the FCPA's internal controls provision related to Oracle's failure to keep proper books and records and to audit local distributors hired by its Indian subsidiary.[37] The SEC's complaint alleged that employees of Oracle India Private Limited—an Oracle subsidiary—structured software sales to the Indian government that inflated the profit margin, which enabled local distributors to hold the excess funds as a ''slush fund.'' Under this alleged scheme, Oracle India then directed the distributors to use the excess funds to pay a number of third-party vendors, none of which had ever provided any services

[28] *In re Sherman*, SEC Admin. Proc. File No. 3-15992, Exchange Act Release No. 72723 (July 30, 2014), *available at* https://www.sec.gov/litigation/admin/2014/34-72723.pdf.

[29] *In re Cummings*, SEC Admin. Proc. File No. 3-15991, Exchange Act Release No. 72722 (July 30, 2014), *available at* http://www.sec.gov/litigation/admin/2014/34-72722.pdf.

[30] According to the SEC, the internal controls at QSGI's Minnesota facility had largely failed by 2008. There were no inventory control procedures and, because of this, warehouse personnel regularly failed to document the removal of items from inventory and accounting personnel failed to adjust inventory in the company's financial reporting system. *See id.*

[31] Sarah N. Lynch, *Update 1-SEC Charges QSGI CEO, Former CFO Over Internal Control Failures*, Reuters, July 30, 2014, *available at* http://www.reuters.com/article/2014/07/30/sec-qsgi-accounting-idUSL2N0Q52M420140730.

[32] 15 U.S.C. § 78l.

[33] *See* 15 U.S.C. § 78dd-1(a).

[34] *In the Matter of Hewlett-Packard Co.*, SEC Admin. Proc. File No. 3-15832, Exchange Act Release No. 71916 (Apr. 9, 2014), *available at* http://www.sec.gov/litigation/admin/2014/34-71916.pdf.

[35] *In the Matter of Smith & Wesson Holding Corp.*, SEC Admin. Proc. File No. 3-15986, Exchange Act Release No. 72678 (July 28, 2014), *available at* http://www.sec.gov/litigation/admin/2014/34-72678.pdf.

[36] *Id.*

[37] *SEC v. Oracle Corp.*, No. 12-cv-4310 (N.D. Cal. Aug. 16, 2012).

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to Oracle India.[38] The SEC contended that the third-party payments created the *risk* that the funds could be used for illegal purposes, such as bribery or embezzlement (even though the investigation did not turn up explicit evidence of improper payment to government officials).[39] To settle the SEC's charges, Oracle agreed to pay a $2 million penalty and consented to an order permanently enjoining it from future violations of the internal controls provisions of the FCPA.

FINRA/FinCEN Supervisory Control Procedures. In addition to SEC enforcement proceedings, FINRA has been active as well. By way of background, FINRA has issued supervisory control procedures that a member firm must adopt to supervise its personnel, and the CEO must certify annually that ''the member has in place processes to establish, maintain, review, test and modify written compliance policies and written supervisory procedures reasonably designed to achieve compliance with applicable FINRA rules . . . and federal securities laws and regulations.''[40] Likewise, FINRA's predecessor, the National Association of Securities Dealers, issued a rule (which is still applicable to FINRA members) that member firms establish, maintain and enforce a supervisory control system.[41]

Recently, FINRA has levied fines against firms that have failed annually to test and verify that the firm's supervisory procedures were sufficient, review internal financial reports, and periodically review the firm's business and procedures.[42] FINRA also has continued its aggressive enforcement of broker dealers with respect to anti-money laundering compliance. For example, in February 2014, FINRA levied the highest fine in its history against Brown Brothers Harriman & Co. (''BBH'') for lack of internal controls regarding money laundering and for failing to sufficiently investigate suspicious activity once it was brought to the firm's attention.[43] FINRA also fined and suspended (for one month) BBH's former global anti-money laundering compliance officer for his role in failing to tailor BBH's anti-money laundering procedures in a way that would adequately detect, investigate and report suspicious activity. In commenting on the matter in response to a Wall Street Journal inquiry, Brad Bennett, FINRA's executive vice president and chief of enforcement, stated that ''where [chief compliance officers] are assigned specific responsibilities in areas that present substantial risks to investors, we expect them to fulfill those responsibilities and will hold those CCOs who fall short accountable consistent with the evidence.''[44]

Since 2010, the Financial Crimes Enforcement Network (''FinCEN''), a bureau of the Treasury Department designed to combat money laundering, along with the Department of Justice (''DOJ''), have significantly increased enforcement of anti-money laundering-related charges against financial institutions for faulty internal controls, specifically, failure to maintain an effective anti-money laundering program, which includes as a central pillar of compliance the development and implementation of internal policies, procedures and controls.[45] Between 2011 and 2014, DOJ initiated ten Bank Secrecy Act prosecutions for failure to have an effective AML program. For example, in a case against HSBC, FinCEN and DOJ alleged that HSBC failed to implement an adequate system of internal controls to ensure ongoing anti-money laundering compliance by failing to: take appropriate steps to adequately assess the risks posed with many of its products and services; effectively risk rate customers; adequately process anti-money laundering risk of the countries within which it transacted business; and implement and maintain a transaction-monitoring regime reasonably designed to detect and report money laundering and other illicit activity.[46] HSBC ultimately resolved the matter with DOJ by agreeing to forfeit $1.256 billion and enter into a Deferred Prosecution Agreement and resolved the matter with FinCEN by consenting to the assessment of a civil money penalty of an additional $500 million

Similarly, FinCEN and the DOJ charged JPMorgan Chase with failing to maintain an effective anti-money laundering program, including the failure to have adequate internal controls, in connection with its role as the primary institution that serviced the Bernard Madoff *Ponzi* scheme. Specifically, JP Morgan Chase failed to complete due diligence of Madoff and failed to adequately detect and report his suspicious activity. JP Morgan Chase ultimately paid a combined penalty of $1.7 billion and entered into a Deferred Prosecution Agreement with DOJ.[47]

In light of the large number and different types of entities that are considered ''financial institutions'' under the Bank Secrecy Act, not to mention that historically there was little enforcement activity directed to non-bank financial institution, many organizations currently may be ill prepared to satisfy an inquiry into the quality of compliance efforts. A mobile payment application, for instance, may offer services that constitute both payments processing and money services, where the latter but not the former is subject to the Bank Secrecy Act.

Practical Considerations. As this discussion illustrates, the issue of internal control failures has assumed greater prominence in recent regulatory settlements, including Bank Secrecy Act actions. Admittedly, while in certain instances the regulatory focus appears to be on internal controls, in others the internal control issue appears to be a secondary concern overshadowed by the

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[38] *Id*.

[39] Press Release, SEC, SEC Charges Oracle Corporation with FCPA Violations Related to Secret Side Funds in India (Aug. 16, 2012), *available at* http://www.sec.gov/News/PressRelease/Detail/PressRelease/1365171483848#VBNfS_ldWE4.

[40] FINRA Rule 3130(b) (2008).

[41] NASD Rule 3012 (2006).

[42] *In the Matter of Headwaters BD, LLC*, FINRA Case No. 2012030462001.

[43] *In the Matter of Brown Brothers Harriman & Co.*, FINRA Case No. 2013035821401.

[44] Rachel Louise Ensign, *Compliance Officer Probes Stir Alarm Among their Peers*, Wall Street Journal, Sept. 15, 2014, *available at* http://blogs.wsj.com/riskandcompliance/2014/09/15/compliance-officer-probes-stir-alarm-among-their-peers/.

[45] FinCEN has civil enforcement authority over the Bank Secrecy Act while the Department of Justice has criminal enforcement authority.

[46] *See In the Matter of HSBC Bank USA N.A.*, Fin. Crimes Enf. Network No. 2012-02 (Dec. 11, 2012); *United States v. HSBC Bank USA, N.A.*, No. 12-CR-763 (E.D.N.Y. 2012)

[47] *See United States v. JPMorgan Chase Bank, N.A.*, No. 14-cr-00007 (S.D.N.Y. Jan. 8, 2014); *In re JPMorgan Chase, N.A.*, Fin. Crimes Enf. Network No. 2014-01 (Jan. 7, 2014).

consequence of the internal control failure, such as the commission of fraud and/or FCPA violations. In either scenario, however, the amount of the monetary penalty and the breadth of remedial measures that a company will have to implement as part of a regulatory settlement very well may hinge in large part on issues directly related to the company's internal control structure and the quality of reporting both before and following discovery of wrongdoing. Companies that appear to have had robust control and reporting systems notwithstanding the fact that misconduct occurred, or that acted vigorously to put in place reforms upon learning of wrongdoing, will have far better odds of being able to resolve charges on relatively more favorable terms.

Responsibility for creating and maintaining effective internal controls starts with the board of directors but ultimately filters throughout an organization. The board, in consultation with senior management and appropriate outside advisors, must ensure that robust internal control policies and procedures are in place and functioning effectively. At the very least, the legal, compliance and finance/accounting departments need to be involved in planning and execution after becoming sufficiently informed about company operations such that appropriate controls can be created and implemented. The CEO and CFO in particular need to be engaged on this issue given their assessment and reporting obligations under Sarbanes-Oxley. Non-management employees also have important roles, which include monitoring their own compliance with applicable rules and regulations, and reporting potential violations to supervisors. And, internal auditors must evaluate on an ongoing basis the sufficiency and effectiveness of internal controls, as well as closely monitor operations, compliance and financial reporting functions.[48]

Given the increased regulatory focus in this area, public companies are advised to consider the following:

- Administering a full assessment of the adequacy of the company's existing internal control and reporting systems (including those of foreign subsidiaries);
- If the existing internal control structure is found to be lacking, working with outside counsel and auditors to determine which improvements or enhancements are necessary;
- Assessing the proficiency and expertise of internal auditors, independent auditors and legal personnel;
- Publicizing to employees on a periodic basis a catalogue of internal control-related requirements, as well as a method for reporting violations and deficiencies; and
- Instituting procedures for handling reports from employees, including assessing the materiality of the reported violation/deficiency, determining the level of investigation warranted, ensuring that senior personnel are kept informed, and preserving all relevant documentation.

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[48] *See* COSO Roles and Responsibilities of Internal Control, *available at* http://www.coso2013.com/roles.php.

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