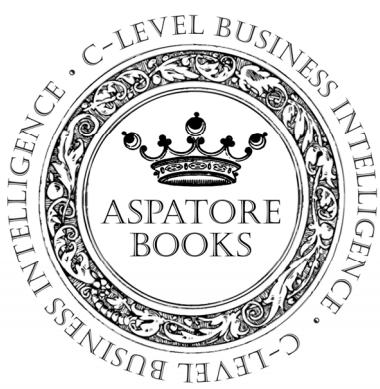


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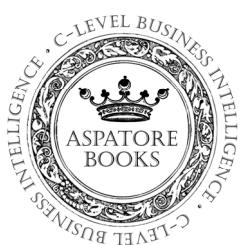


# The Law of Unintended Consequences: International Trade Compliance in the Age of Sarbanes-Oxley

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## Introduction

Ongoing changes in the way the U.S. government regulates international business present growing compliance challenges for companies that are listed with the U.S. Securities Exchange Commission (SEC). Although the business community is already well acquainted with the SEC's focus on internal accounting controls under the Sarbanes-Oxley law (SOX), the agency's evolving focus on international business that touches U.S. national security sensitivities is still relatively obscure. Since 2004, the SEC has been quietly examining the international activities of listed companies that involve countries designated as "State Sponsors of International Terrorism" under the U.S. export control laws and preparing for a more active role on these issues. This trend has far-reaching implications for the trade compliance practices of public companies.

Because SOX generally requires public companies to maintain effective internal controls in all areas of business conduct, the SEC's new focus on international business and U.S. trade restrictions introduces SOX considerations into standards of compliance under U.S. trade control laws that are grounded in U.S. foreign policy and national security concerns. These laws include U.S. export controls administered by the Departments of Commerce, State and Energy (EAR, ITAR, Antiboycott, DOE/NRC), economic sanctions regimes administered by the Treasury Department's Office of Foreign Assets Control (OFAC), provisions of the Foreign Corrupt Practices Act (FCPA) administered by the Department of Justice and the SEC and U.S. customs laws administered by Customs and Border Protection within the Department of Homeland Security (CBP). Accelerating globalization of business multiplies the compliance risks these laws present for companies in almost any business sector.

While encouraged by agency guidance and incentives, the U.S. trade control regimes (apart from the FCPA) generally do not require that companies maintain formal trade compliance programs. In practice, many companies develop trade compliance safeguards on an ad hoc basis, as regulatory requirements affect the growth of their business. Outside the defense sector, trade compliance is often approached more as a matter of business administration than as an executive suite priority. Although many executives understand the need to list trade compliance in codes of ethics and conduct,

they often fail to appreciate the need to develop a detailed trade compliance program until after they encounter the substantial costs of enforcement action.

A growing number of U.S. companies are formalizing their internal controls for international trade compliance with SOX considerations in mind. As more companies follow this path, the benchmarks of trade compliance that other companies will be judged against—whether in regulatory enforcement proceedings or hostile shareholder action—are steadily rising. Accordingly, trade compliance programs must be crafted in reference to business best practices as well as agency guidance. In the current climate, establishing a comprehensive international trade compliance program is increasingly a matter of necessity for global companies.

### **Regulatory Convergence at the SEC**

On June 25, 2007, the SEC launched a new Web site identifying public companies that have business activities involving countries that are designated as “State Sponsors of International Terrorism” under the U.S. export control laws, including Iran, Syria, Sudan, and Cuba [*see* <http://www.sec.gov/news/press/2007/2007-121.htm>]. In doing so, the agency stated that the action was taken to assure that investors have access to such information, which could be viewed as material to investment decisions. This development occurred at a time of increasing initiatives in Congress, various state legislatures, and at the grassroots level to require investors to divest holdings in public companies with business interests in “state sponsor” countries. Accordingly, the SEC’s Web site provided a basis for hostile targeting of named companies.

Public filings show that only a small percentage of the overall revenue of many companies identified on the SEC list is actually attributable to business in state sponsor nations. The SEC list did not claim to be a comprehensive catalog of all companies that have business interests in the state sponsor countries. Moreover, the SEC did not actually assert that the activities of named companies were in any way contrary to U.S. law. In fact, foreign companies listed with the SEC and foreign subsidiaries of U.S. entities that operate independently outside the United States can engage in offshore business with state sponsor nations without violating current U.S.

trade restrictions. Within a month of the Web site's launch, the SEC announced a temporary suspension of the online listing to "improve" this Web tool by addressing accuracy concerns raised by the business community. However, this action remains indicative of a significant new focus of attention at the SEC.

Although publication of the SEC's state sponsors list came as an unwelcome surprise to many in the corporate world, it follows a sustained process of information gathering that began more than three years ago. In late December 2003, Congress enacted legislation mandating the creation of a new office at the SEC—the Office of Global Securities Risk (OGSR)—to: (1) assure that information on business activities of listed companies in state sponsor countries is collected and made available to the public; (2) to coordinate these efforts with the key U.S. enforcement agencies that administer U.S. export controls, economic sanctions, and other trade control laws; and (3) to secure international cooperation with foreign counterparts of the SEC in other countries to support OGSR's mission.

Prior to enactment of the Sarbanes-Oxley law, the SEC already had a long-standing mandate to assure public companies maintain accurate books and records and effective compliance controls, under the Foreign Corrupt Practices Act of 1977 (FCPA). In the long shadow of September 11, 2001, as the SEC focused on intensifying efforts to prosecute notorious accounting fraud cases born out of the corporate scandals of the late 1990s and compel public companies to implement SOX-based financial controls, Congress and the executive branch took systematic steps to apply the existing framework of U.S. trade controls in support of national security priorities in the U.S. War on Terrorism.

The Office of Global Security Risk was established in early 2004 as part of efforts to focus executive branch resources on War on Terrorism priorities. Whether intended or not, its creation set in motion an ongoing process of regulatory convergence that brings international trade compliance practices into a parallel orbit with broader standards of corporate governance, accountability, and best practices.

Publication of the SEC's state sponsors list and OGSR's activities are particularly significant in the context of ongoing efforts by elected officials,

at the national and state level, to impose greater restrictions on commercial activities involving such countries of concern. A number of influential U.S. communities of interest are aggressively promoting measures to impose greater restrictions on access to international capital and resources by state sponsor countries by amending established U.S. export controls and sanctions laws. In 2007, more than a dozen bills have been introduced in Congress, with strong bipartisan support, to expand U.S. extraterritorial sanctions against foreign companies and foreign subsidiaries of U.S. entities with commercial activities in state sponsor countries. This trend also extends to the state level, where a growing number of state governments have adopted or are considering compulsory divestment sanctions laws that mandate divestment of holdings in public companies (whether they are listed in the U.S. or on overseas exchanges) that have offshore business interests in Iran, Sudan or other state sponsor countries.

In this political climate, an increasing number of prominent U.S. companies, including General Electric, Halliburton and others, have taken steps to wind down or sell foreign subsidiaries with activities in state sponsor countries. At the same time, a growing number of foreign investors are turning away from the United States in favor of other markets, as these trends and new U.S. investment restrictions under recent amendments to the Exon-Florio law and CFIUS review procedures subject U.S. investments to greater burdens and risk. These trends compound trade compliance risks for U.S. companies active in global markets by scattering potential conduits for prohibited diversion of U.S. controlled goods, technology, and capital, increasing the burdens of due diligence in international transactions and enlarging the challenges of compliance with U.S. trade controls in contacts with foreign companies.

## **Client Challenges**

*Affected Business Sectors.* International trade control concerns are not limited to “sensitive goods” with military applications. These issues can arise in almost any sector. My own experience includes work with clients in a wide range of industries, from producers of basic commodities to high-tech companies on the cutting edge of IT. Trade compliance concerns can affect almost any kind of business to the extent that its activities involve international commerce or contacts with foreign nationals.

*Enforcement.* While companies that engage in global business are increasingly aware of U.S. trade restrictions, many do not take a systematic approach to trade compliance until after they experience trade enforcement action. Whether subject to enforcement due to the bribery of foreign officials by offshore agents, the discovery of unauthorized re-exports by a foreign subsidiary, or by pre-acquisition trade control violations of a newly acquired company, companies often fail to understand the magnitude of costs associated with violations of these laws, even when violations are unintended, until it is too late. Enforcement of U.S. trade controls is an increasing priority of the executive branch. This is reflected in the recent creation of an interdepartmental Counter-Proliferation Task-Force to combat exports of military and dual use technology and establishment of a National Coordinator for Export Enforcement at the Department of Justice to coordinate with other agencies that administer U.S. trade controls, and in the recent five-fold increase in statutory civil penalties for violations of U.S. sanctions and export control laws. High profile prosecutions of FCPA, export control, sanctions and customs cases have multiplied exponentially in recent years. Until now, company decisions to develop a comprehensive trade compliance program have commonly been in response to enforcement experience rather than pro-active. However, these trends increasingly put companies on notice that the costs of non-compliance are foreseeable and high.

*Mergers, Acquisitions and Successor Liability.* Post-acquisition trade enforcement cases can rewrite the value of major acquisitions and other corporate transactions. Most of the core U.S. trade control laws apply on a strict liability basis and successor liabilities carry over to acquiring companies. Many of the largest penalty assessments in recent U.S. export controls, sanctions, and FCPA cases involve successor liability scenarios and situations where an acquiring company did not adequately consider trade compliance assessment in pre-acquisition due diligence. In the absence of a top-down compliance program that includes considered provisions for the conduct of relevant due diligence in corporate transactions, a large company that experiences substantial growth through serial acquisitions in a compressed period of time can later find that the discovery of trade compliance problems at one subsidiary unravels wider systemic problems involving other entities.

Apart from substantial penalties, trade control enforcement can also generate significant adverse publicity and erode share value. The close association of U.S. trade restrictions with sensitive counter-terrorism, non-proliferation and narcotics trafficking concerns often makes such cases particularly damaging to a company's customer, supplier, and investor relations.

*Voluntary Disclosures.* In cases where a company identifies prior violations of U.S. trade controls, voluntary self-disclosure, cooperation with relevant agency officials, and negotiated settlement can often provide the best path to a resolution of related legal concerns. Voluntary self-disclosures are recognized as a significant mitigating factor in the context of settlement by the agencies that administer U.S. trade controls, consistent with federal sentencing guidelines. These agencies also treat the existence of an internal compliance program as an important mitigating consideration in penalty assessment. In the context of voluntary disclosures, the creation or strengthening of a comprehensive trade compliance program can be presented as a key remedial action in seeking a positive resolution with agency officials.

## **Imperatives to Establish Effective Trade Compliance Controls**

*Strict Liability.* As indicated above, U.S. export controls, sanctions, and other trade regimes apply on a strict liability basis. This means that substantial penalties apply to violations regardless of whether they are willful or unintended. Potential penalties include civil and criminal fines of millions of dollars. Moreover, responsible company officials are subject to possible imprisonment. Administrative penalties include denial of export privileges and statutory debarment, which can amount to an economic death sentence for a company that has critical markets abroad or is heavily dependent on work under U.S. government contracts.

Beyond statutory penalties, the key agencies that administer U.S. trade controls are increasingly making publicity of trade control cases a hallmark of their enforcement practices. While this is done to deter misconduct by others, it amplifies the business costs of enforcement for affected companies. As the SEC's recent listing of companies with business interests in state sponsor countries indicates, increasing public disclosure

requirements, paired with growing shareholder activism against companies with holdings that skate close to the line of U.S. trade controls, can significantly alter the economics of holdings that beg questions under these regimes.

*Mitigation and Best Practices.* As also discussed above, federal sentencing guidelines and relevant agency guidance recognize the existence of an internal compliance program as an important mitigating factor in consideration of penalties for violations of U.S. trade controls. Apart from the FCPA, the U.S. export control, sanctions, and other trade control laws do not require companies to maintain comprehensive trade compliance programs. However, the convergence of broader U.S. foreign policy and national security priorities with these issues, developments at the SEC, and globalization is expanding the scope of activities in which U.S. trade controls need to be considered. While many companies have developed trade compliance programs in the past, compliance benchmarks in the corporate community are evolving on an ongoing basis, as the U.S. regulatory climate continues to change and more companies develop compliance programs keyed to other corporate controls informed by SOX considerations.

*Risk.* Trade compliance obligations can arise wherever international flows of financial, human or technological capital occur. International trade and transactions, including mergers, acquisitions, and joint ventures involving non-U.S. assets, raise potential trade control concerns. Moreover, non-commercial contacts with foreign business partners, clients, and customers, in the U.S. or abroad, can trigger “deemed export” restrictions on the transfer of U.S.-origin technology or know-how to foreign nationals. In the current U.S. climate, companies with international business interests that do not formalize their trade compliance practices are increasingly disadvantaged if they are subject to enforcement, both in penalty assessment and in the way that their shareholders, business partners, and capital markets react.

## **Compliance Benchmarks and Agency Guidance**

The practical benchmarks for trade compliance programs are ever-changing, as industry practices and investor expectations evolve over time.

But in the age of Sarbanes-Oxley, the imperative for global companies to maintain rigorous international trade controls is increasingly a matter of industry best practices, market expectations and the expectation of government regulators.

Beyond the initiation of a trade compliance program, a company must apply diligent oversight to assure that its program is implemented and maintained in an effective way. The program must be audited and amended to accommodate relevant changes of law and changes in the company's business profile.

General guidance published by the agencies with principal jurisdiction over U.S. trade control regimes delineates a number of key elements for any trade compliance program. These include:

- Management commitment and a clear statement of compliance policy
- Designation of responsible officials
- Effective internal communications resources
- Standards and procedures
- Internal review and audit mechanisms
- Training and education
- Effective record-keeping mechanisms

For importers, verifiable supply chain security safeguards are critical qualifying considerations for participation in the Customs-Trade Partnership (C-TPAT), which rewards participating companies with more favorable customs processing and entry of goods into the United States.

Although most companies build these elements into their compliance programs, this can be done in a variety of ways and different approaches may be followed. As discussed below, well-designed programs generally include a number of common objectives and features.

## **Development of Effective Trade Compliance Programs**

There is no “one size fits all” template for trade compliance programs. Agency guidance and enforcement practice clearly indicate that a compliance program must be closely tailored to the way a company is

organized and operates, the scope of its business, the nature of its goods, technology, and services, and the markets in which it does business. Such programs should be comprehensive in scope, with emphasis on the areas of trade regulation most relevant to a company's operations. Many companies find it practical to integrate trade compliance guidance into established codes of conduct and their broader framework of corporate controls. To prevent violations and assure that a program is viewed favorably by U.S. regulators, it must be maintained on a vigilant basis.

*Top-Down Commitment.* The most important factor in the success of any trade compliance program is the level of support provided by senior management. The effectiveness of a program largely depends on the culture of compliance a company establishes from the top down, the way in which this is communicated and reflected in implementation of compliance safeguards, and the way the program is maintained over time.

*Collaboration.* In my own experience, projects to develop comprehensive trade compliance programs are most successful when approached as a close collaborative effort of the company and outside counsel, working together as a team. At the outset, outside counsel should learn as much as possible about the company's core business, including its market position, business strategy, and commercial goals, through discussions with key company officials, review of public filings and non-public information provided for this purpose. Knowledge of the company's business interests makes it possible to develop a compliance program that incorporates established resources and business practices and thus minimizes disruption of company operations. Tailoring the program to established practices makes it easier for company personnel to integrate compliance safeguards into existing routines. Ultimately, this makes the compliance program less costly, less burdensome and easier to implement, and consequently more effective.

*Compliance Assessment and Framework.* The compliance team should make an initial assessment of the company's compliance risk profile, existing compliance safeguards, and participation or eligibility for certification in cooperative programs such as C-TPAT, to establish the basis to develop a framework that addresses the company's compliance needs. This should include review and consideration of the company's international trade in goods and services, its foreign assets, international business partners and

commercial relationships, activities in sensitive regions or markets, production or use of sensitive technology, and other factors. The assessment should also include review of any past compliance problems, established trade compliance policies, procedures, and other safeguards, as well as interviews with key personnel to evaluate their knowledge of how relevant trade controls affect the company's operations. Any trade control violations identified in the review should be subject to close evaluation to identify weaknesses in established safeguards, develop remedial solutions and determine any action needed to reach appropriate resolution with relevant agencies.

Once this assessment is complete, the key focus can turn to development of the compliance framework. This framework should be grounded in established compliance practices and resources while building out the program to address areas of vulnerability. The program should also include provisions for appropriate levels of training of affected personnel, assignment of compliance responsibilities, clear channels for communications, and resources to support the program over time.

*Objectives.* Key objectives of trade compliance programs typically include:

- Establishing effective safeguards to assure compliance with applicable licensing requirements or restrictions
- Integrating compliance safeguards with established corporate governance and internal control mechanisms, policies, and procedures that address other substantive concerns
- Implementing core compliance policies, procedures, and safeguards across business divisions to harmonize practices and facilitate compliance management
- Assigning appropriate levels of authority to empowered officials at different subdivisions or business units
- Developing appropriate levels of self-sufficiency at the corporate level and among relevant operational personnel
- Establishing clear lines of communication and a chain of authority
- Providing necessary information and reference materials to maintain current understanding and support compliance implementation by responsible officials on a cost-effective basis

- Providing responsible officials at different business divisions with ongoing guidance and training on relevant areas of regulation, including relevant changes in law

*Features.* Common features of benchmark programs include:

- A clear statement of trade compliance policy and senior management commitment.
- A compliance manual that reflects the overall scope and architecture of the program, identifies key personnel, provides guidance on key compliance subjects, sets out basic policies and procedures, obligations of company personnel and consequences of non-compliance.
- Written and online compliance resources, including basic information on relevant trade controls, points of referral for guidance and management of registration or licensing requirements, instructions on referral of compliance questions or concerns, and information on relevant compliance resources.
- Transaction and customer screening mechanisms, including screening software to prevent transactions with prohibited parties.
- Procedures to identify and comply with licensing requirements under relevant trade controls.
- Training and education resources, including online materials, in-house and commercial training seminars and other mechanisms to assure that company personnel maintain an appropriate understanding of relevant trade controls.
- Internal reporting and audit mechanisms
- Record-keeping requirements, including identification of relevant documents for retention and allocation of record-keeping responsibilities.

## **Legal Fees and Value**

*Cost.* Legal fees associated with the development of a comprehensive international trade compliance program can be substantial. The actual cost in a specific case depends on a variety of factors, including the nature of a company's risk profile, its compliance history, established internal trade

controls, the number and locations of affiliated entities, the level and quality of participation in the project by company personnel, the impact of unanticipated compliance problems discovered in review, and other variables. Generally, the more systematic and comprehensive the compliance assessment, the more efficiently such projects can be completed.

*Benefits.* The up-front costs of establishing a trade compliance program should be measured against the potential savings that an effective program generates over time. Once a program is established, it should significantly reduce legal fees to outside counsel for assistance with licensing, classification and routine guidance on other issues that can be handled independently. An effective trade compliance program also should facilitate more effective business planning by integrating assessment of trade regulation requirements in consideration of proposed commercial activities. More fundamentally, an effective program will prevent a company from incurring the substantial costs typically associated with trade control violations.

*Value.* When properly crafted consistent with a company's needs and relevant best practices, a trade compliance program should enhance a company's market value. A program that is built on compliance benchmarks understood by other companies and government regulators also advances a company's relations with key agencies, business partners, and investors in ways that leverage value in financial markets.

## **Conclusions**

The intersection of U.S. national security and foreign policy priorities with U.S. trade controls and corporate governance standards at the SEC under Sarbanes-Oxley has created a regulatory environment in which the implementation of a comprehensive international trade compliance program is increasingly less a matter of convenience and more a matter of necessity for global companies with a stake in the U.S. market. While it is unclear if the SEC or private investors will at some point directly assert that SOX Section 404 standards require a company to maintain effective internal controls for international trade compliance, current trends point in that direction.

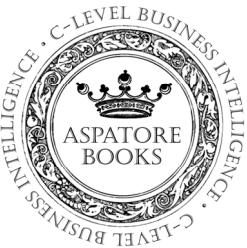
Regardless of whether or not standards of trade compliance are framed in reference to SOX Section 404, the trade compliance expectations of U.S. regulators and private investors are steadily rising as a growing number of U.S. companies develop more systematic practices, procedures, and programs. As the benchmarks of trade compliance escalate, the need for companies to develop strong trade control programs is rising.

It is also uncertain if legislative or regulatory action will ever require that companies maintain formal trade compliance programs under U.S. export controls, sanctions, customs or other trade control laws. However, the current regulatory enforcement climate already makes it clear that establishing a formal program is essential as a matter of prudence and best business practices, consistent with emerging trends in the corporate community.

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