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A Global Anti-Corruption Newsletter

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Beyond "Virtual Strict Liability": SEC Brings First FCPA Enforcement Action of 2018

On March 9, 2018, the Securities and Exchange Commission ("SEC") entered into a Cease & Desist Order with Elbit Imaging Ltd. ("Elbit"), a NASDAQ-traded Israeli holding company focusing on, among other things, real estate development (the "Elbit Order").[1] The Elbit Order states that the company is currently in the process of winding down.[2] The basic findings in the Elbit Order are that Elbit, by itself and through its indirect but "functional[ly] control[led]" subsidiary, violated the books and records and internal controls provisions of the U.S. Foreign Corrupt Practices Act ("FCPA") in connection with approximately $27 million in payments

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1. *In the Matter of Elbit Imaging Ltd.*, Order Instituting Cease-and-Desist Proceedings Pursuant to Section 21C of the Securities Exchange Act of 1934, Making Findings, Imposing a Cease-and-Desist Order, and Imposing a Civil Monetary Penalty, at ¶ 1, Securities Exchange Act Rel. No. 82849, Accounting and Auditing Enforcement Rel. No. 3925, Admin Proc. File No. 3-18397 (March 9, 2018), https://www.sec.gov/enforce/34-82849-s. (hereinafter the "Elbit Order").
2. Elbit Order at ¶ 28.

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to third parties between 2007 and 2012, relating to two separate transactions: (i) real estate development in Romania; and (ii) the sale of a US real estate portfolio.[3]

The Elbit Order continues a trend in SEC enforcement actions – dating back at least to the 2012 enforcement action against Oracle[4] – of charging violations of the accounting provisions without any specific findings of bribery or, alternatively, "illicit" or "improper" payments. Similar actions also have been brought outside the foreign bribery context, most notably the SEC's 2016 cease-and-desist order against Continental and United Airlines.[5] The Elbit Order, with regard to the real estate development in Romania, like 2017's Cadbury Mondelez settlement,[6] takes this trend even further, by charging a violation of the books and records and internal controls provisions based only on a finding that "there is no evidence to suggest" that due diligence was done and that "there is no documentation or other evidence showing" any services rendered by the consultants. This, coupled with a vague assertion that therefore something bad (bribery or embezzlement) "could have" or "may have" happened, forms the basis of the SEC's Elbit Order.

As such, the Elbit Order once again highlights the breadth of the SEC's interpretation of the accounting provisions and underscores the importance of internal controls and proper documentation of transactions involving "red flags." At the same time, the Elbit Order raises the question of whether the SEC's interpretation of the accounting provisions is too broad, as it suggests that the SEC need only find the absence of such documentation (without more) in order to make its case. We recognize that parties settle for a variety of reasons many of which have little to do with liability. However, it seems unlikely that the SEC would actually litigate such actions based on unsubstantiated, inchoate claims.

The Elbit Order

Like in other cease-and-desist orders, Elbit did not admit or deny the allegations therein, except as to jurisdiction. The Elbit Order finds that Elbit "exert[ed] functional control" over Plaza Centers NV ("Plaza"), its indirect subsidiary incorporated in the Netherlands, the financial results of which were consolidated

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3. *Id.* at ¶¶ 10, 17, 27.
4. *SEC v. Oracle Corporation*, Complaint, Case CV-12-4310-CRB (N.D. Cal. Aug. 1, 2012), https://www.sec.gov/news/press-release/2012-2012-158htm. ("Oracle Order").
5. *See In the Matter of United Cont'l Holdings, Inc.*, Exchange Act Release No. 79454, 2016 WL 7032725 (Dec. 2, 2016); Paul R. Berger, Colby A. Smith, Jonathan R. Tuttle, Ada Fernandez Johnson, Alice N. Barrett, "Failure to Comply with Internal Corporate Processes and Policies May Violate FCPA Accounting Provisions," FCPA Update, Vol. 8, No. 5 (Dec. 2016), https://www.debevoise.com/~/media/files/insights/publications/2016/12/fcpa_update_december_2016.pdf.
6. *In the Matter of Cadbury Limited and Mondelez International, Inc.*, Order Instituting Cease-and-Desist Proceedings Pursuant to Section 21C of the Securities Exchange Act of 1934, Making Findings, and Imposing a Cease-and-Desist Order, Securities Exchange Act of 1934 Rel. No. 79753, Accounting and Auditing Enforcement Rel. No. 3841, Admin. Proc. File. No. 3-17759 (Jan. 6, 2017) (hereinafter "Cadbury Order").

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into Elbit between 2007 and 2012.[7] Prior to 2014, Elbit's CEO, "Executive A," was the executive director of Plaza, owned approximately 50% of Elbit, and sat on the boards of both companies. Executive A died in June 2016.[8]

The Romania Findings

The Elbit Order finds that in 2006, Executive A directed Plaza to enter into a contract with "a third-party offshore entity" for consulting services relating to a property development project in Romania. Among the duties of the consultant was to obtain an invitation from the Romanian government to participate in a tender for a shopping mall development and to acquire necessary government approvals. According to the Elbit Order, Plaza successfully obtained a 75% interest in the project, but "there [wa]s no evidence to suggest that Plaza conducted any due diligence" on the consultant and there was "no documentation or other evidence showing that [the consultant] provided any services."[9]

"The Elbit Order continues a trend in SEC enforcement actions . . . of charging violations of the accounting provisions without any specific findings of bribery or, alternatively, 'illicit' or 'improper' payments."

In 2011, Executive A directed Plaza to enter into another contract with a different third-party offshore entity to provide consulting services relating to obtaining Romanian government approvals necessary to purchase an additional 15% interest in the project from the government. Again, there was "no documentation or other evidence" of any due diligence on the third-party consultant and "no evidence to suggest" that the third party consultant performed any work.[10] Between 2007 and 2012, Plaza paid approximately $14 million to these consultants, which were authorized by Plaza's management, even though the supporting documentation did not identify the services the consultants performed.[11] The statement of facts

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7. Elbit Order at ¶¶ 1-2.
8. *Id.* at ¶ 3.
9. *Id.* at ¶¶ 6-7.
10. *Id.* at ¶¶ 8-9.
11. *Id.* at ¶10.

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relating to Romania concludes with the following statement (substantively repeated in the section of the Elbit Order regarding Elbit's deficient books and records and internal controls):

> Plaza characterized the payments to the consultants in its books and records as legitimate business expenses for services rendered, when some or all of the funds *may have been used* to make corrupt payments to Romanian government officials or were embezzled.[12]

The US Real Estate Portfolio Findings

Finally, the Elbit Order finds that in 2011, Elbit and Plaza together owned a 45.4% interest in a joint venture which sought to sell a portfolio of US real estate assets. Executive A directed both companies to retain a sales agent ("Sales Agent A"), on which they did not conduct due diligence. "Unbeknownst to Elbit and Plaza," Sales Agent A passed on 98% of the commission received to Sales Agent B, which was indirectly beneficially owned by Executive A. The Elbit Order finds that "no evidence suggests that Sales Agent A or Sales Agent B provided" any services and that there was evidence that another third party was retained by the joint venture to provide the same services. Further, the third party retained by the joint venture was paid approximately half of the $13 million paid by Elbit and Plaza to Sales Agent A ($12.75 million of which was transferred to Sales Agent B).[13]

When it discovered the transactions in March 2016 and April 2017, Elbit appointed an internal committee to investigate, self-reported to authorities in the US and Romania,[14] and cooperated with the SEC's investigation.[15] Elbit is currently winding down and is not developing current or new business.[16] The SEC assessed a $500,000 civil monetary penalty on Elbit,[17] which took into consideration Elbit's self-reporting and cooperation as well as its ability to pay, although the Elbit Order does not provide specifics as to the SEC's calculation.[18]

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12. *Id.* at ¶¶ 10, 20 (emphasis added).
13. *Id.* at ¶¶ 11-17.
14. Elbit Imaging Ltd., Form 20-F for the fiscal year ended December 31, 2015 at 7 (filed Apr. 21, 2016), https://www.sec.gov/Archives/edgar/data/1027662/000121390016012688/f20f2015_elbitimaginc.htm; Elbit Imaging Ltd., Form 20-F for the fiscal year ended December 31, 2018 at 8 (filed Nov. 9, 2017), https://www.sec.gov/Archives/edgar/data/1027662/000121390017011723/f20f2016_elbitimaging.htm.
15. Elbit Order at ¶ 27.
16. *Id.* at ¶ 28.
17. *Id.* at p. 7.
18. Securities and Exchange Commission, "SEC Charges Elbit Imaging Ltd. With Violating Books and Records and Internal Accounting Controls Provisions of the FCPA," https://www.sec.gov/enforce/34-82849-s.

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The FCPA's Books and Records and Internal Controls Provisions

Although passed as part of the FCPA in 1977, the SEC (and at least one court) have used the accounting provisions to "make and keep books, records, and accounts which, in reasonable detail, accurately and fairly reflect the transactions and disposition of the assets of the issuer"[19] (the books and records provisions) and to "devise and maintain a system of internal accounting controls"[20] (the internal controls provisions) to broadly "address management misfeasance, misuse of corporate assets and other conduct reflecting adversely on management's integrity"[21] regardless of whether the underlying conduct involves overseas corruption.[22] The accounting provisions have been used by the SEC in other administrative actions linked to management embezzlement or self-dealing unrelated to foreign corruption,[23] similar to the findings relating to the sale of US portfolio assets in the Elbit Order.

In the context of foreign bribery, it is not unusual for corporations to settle FCPA enforcement actions involving allegations of "improper payments" or "bribes" with the SEC[24] (and DOJ[25]) in terms of a violation of the books and records and internal controls provisions, often with a foreign subsidiary agreeing to anti-bribery charges.

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19. 15 U.S.C. § 78m(b)(2)(A).
20. 15 U.S.C. § 78m(b)(2)(B).
21. *SEC v. World-Wide Coin Investments, Ltd.*, 567 F.Supp. 724, 748 (N.D. Ga 1983).
22. *See, e.g., id.* (use of internal controls and books and records provisions in an accounting fraud case).
23. *See, e.g., In the Matter of Badree Komandur, ACA, et al.*, Order Instituting Public Administrative and Cease-and-Desist Proceedings Pursuant to Sections 4C and 21C of the Securities Exchange Act of 1934 and Rule 102(e) of the Commission's Rules of Practice, Making Findings, and Imposing Remedial Sanctions, a Cease-and-Desist Order, and a Civil Penalty at ¶¶ 3-6, Securities Exchange Act Release No. 79669, Accounting and Auditing Enforcement Release No. 3837, Admin. Proc. File No. 3-17746 (Dec. 22, 2016) (accountant embezzled money from employer and was involved in other misconduct, including personal transactions with his supervisors, and hid his misconduct through fraudulent accounting entries causing the firm to violate "the reporting, books and records and internal controls provisions of the Exchange Act in connection with the misstatements"); *SEC v. Hollinger Intern., Inc.*, 2004 WL 2815653 (N.D. Ill. January 16, 2004) (involving misstatements by defendant corporation "regarding certain unauthorized transfers of assets of at least $32 million to corporate insiders and related entities").
24. For example, the cease-and desist order against Inbev concerned violations of the books and records and internal controls provisions, even though the underlying conduct described involved "improper payments" by Inbev's Indian subsidiary, in *In the Matter of Anheuser-Busch Inbev SA/NV.*, Order Instituting Cease-and-Desist Proceedings Pursuant to Section 21C of the Securities Exchange Act of 1934, Making Findings, and Imposing a Cease-and-Desist Order at ¶ 1, Securities Exchange Act of 1934 Rel. No. 78957, Accounting and Audit Enforcement Rel. No. 3808, Admin. Proc. File. No. 3-17586 (Sept. 28, 2016); *see also In the Matter of GlaxoSmithKline*, Order Instituting Cease-and-Desist Proceedings Pursuant to Section 21C of the Securities Exchange Act of 1934, Making Findings, and Imposing a Cease-and-Desist Order at ¶ 1, Securities Exchange Act of 1934 Rel. No. 79005, Accounting and Auditing Enforcement Rel. No. 3810, Admin. Prov. File No. 3-17606 (Sept. 30, 2016) (involving Chinese subsidiaries "schemes to corruptly transfer things of value to foreign officials"); *In the Matter of Nordion (Canada) Inc.*, Order Instituting Cease-and-Desist Proceedings Pursuant to Section 21C of the Securities Exchange Act of 1934, Making Findings, and Imposing a Cease-and-Desist Order at ¶ 11, Securities Exchange Act of 1934 Rel. No. 77290, Admin. Proc. File No. 3-17153 (March 3, 2016) (involving a "bribe scheme" between an agent in Russia and a Nordion employee).
25. *See, e.g., U.S. v. Alstom S.A.*, 3:14-cr-00246-JBA (D. Conn. 2014), https://www.justice.gov/opa/pr/alstom-pleads-guilty-and-agrees-pay-772-million-criminal-penalty-resolve-foreign-bribery (Parent company pleaded guilty to violating the books and records and internal controls provisions of the FCPA and subsidiaries pleaded guilty for conspiring to violate the anti-bribery provisions of the FCPA.); *U.S. v. Tyco Valves & Controls Middle East, Inc.*, 1:12-cr-00418-CMH (E.D. Va. 2012), https://www.justice.gov/opa/pr/subsidiary-tyco-international-ltd-pleads-guilty-sentenced-conspiracy-violate-foreign-corrupt (Subsidiary pleaded guilty for conspiring to violate the anti-bribery provisions of the FCPA and the parent company agreed to pay a penalty for falsifying books and records in connection with the payments by its subsidiaries).

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This could reflect the company's preference for avoiding the allegations of violating the anti-bribery provisions or may signal that the underlying facts fail to meet the jurisdictional thresholds of the anti-bribery provisions, thereby operating as "virtual strict liability"[26] for the actions of the issuer's foreign subsidiary.

Books and Records and Internal Controls Actions with No Bribery Charge

It is common for SEC enforcement actions alleging books and records and internal controls violations to include bribery language ("bribe" or "improper payments") without including an allegation of a violation of the anti-bribery provisions of the FCPA. However, since 2012, the SEC has brought a handful of actions that instead allege "heightened" or "significant" risks of bribery without an outright allegation or finding of improper payments. For example:

- In *SEC v. Oracle Corp.*,[27] the SEC alleged that Oracle made payments that "created the potential that they could be used for bribery or embezzlement,"[28] while including allegations of irregular accounting practices.[29]
- In its settlement with BHP Billiton,[30] the SEC alleged violations of the books and records and internal controls provisions because "inviting foreign officials to the Olympics created a heightened risk of violating anti-corruption laws."[31] The cease-and-desist order contained detailed findings relating to specific packages provided to the foreign officials,[32] even though these were not found to be bribes.
- And in last year's cease-and-desist order with Halliburton,[33] Halliburton was found to have violated the books and records and internal controls provisions because it made payments to an Angolan local content contractor, deliberately

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26. We have previously explored this concept in, among other places, Paul R. Berger, Andrew M. Levine, Bruce E. Yannett, and Philip Rohlik, "SEC Brings First FCPA Enforcement Actions of 2016," at 4, FCPA Update, Vol. 7, No. 7 (Feb. 2016), https://www.debevoise.com/~/media/files/insights/publications/2016/02/fcpa_update_february_2016.pdf.
27. Oracle Order, *supra* note 4.
28. *Id.* at ¶¶ 1, 13, 16.
29. *Id.* at ¶ 1.
30. *In the Matter of BHP Billiton Ltd. And BHP Billiton Plc.*, Order Instituting Cease-and-Desist Proceedings Pursuant to Section 21C of the Securities Exchange Act of 1934, Making Findings, and Imposing a Cease-and-Desist Order, Securities Exchange Act of 1934 Rel. No. 74998, Admin. Proc. File. No. -16546 (May 20, 2015); *see also* Andrew M. Levine, Bruce E. Yannett, Matthew Getz, Steven S. Michaels, and Philip Rohlik, "Internal Controls of Olympic Proportions: BHP Billiton Settles SEC Investigation of Olympic Hospitality," FCPA Update, Vol. 6, No. 10 (May 2015), https://www.debevoise.com/~/media/files/insights/publications/2015/05/fcpa_update_may_2015.pdf.
31. *Id.* at ¶ 2.
32. *Id.* at ¶¶ 26-34.
33. *In the Matter of Halliburton Company and Jeannot Lorenz*, Order Instituting Cease-and-Desist Proceedings Pursuant to Section 21C of the Securities Exchange Act of 1934, Making Findings, and Imposing a Cease-and-Desist Order, Securities Exchange Act of 1934 Rel. No. 81222, Accounting and Auditing Enforcement Rel. No. 3884, Admin Proc. File No. 3-18080 (July 27, 2017); *see also* Kara Brockmeyer, Andrew M. Levine, and Philip Rohlik, "Summer Enforcement Actions (and Non-Actions): Halliburton, Guilty Verdicts, and Declinations," FCPA Update, Vol. 9, No. 1 (Aug. 2017), https://www.debevoise.com/~/media/files/insights/publications/2017/08/fcpa_update_august_2017.pdf.

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overriding internal controls put in place following a roughly contemporaneous settlement with the SEC.[34] While the cease-and-desist order is replete with findings about the local content contractor's close relationship with a senior official at Halliburton's state-owned customer,[35] there is no explicit finding of bribery, or even of the risk of bribery or embezzlement.

Beyond Virtual Strict Liability

While not using bribery language and finding only "the potential," or "heightened risk" or "significant risk" of bribery, each of the above settlements contained either explicit findings of accounting irregularities (Oracle) or detailed findings relating to relationships with or benefits provided to foreign officials (BHP Billiton and Halliburton). However, in the Elbit Order and last year's cease-and-desist order against Cadbury Limited and Mondelez International[36] (the "Cadbury Order") the SEC brought administrative orders alleging violations of the accounting provisions without either bribery language or factual findings to support either bribery *or* accounting irregularities.[37]

"[T]he Elbit Order once again highlights the breadth of the SEC's interpretation of the accounting provisions and underscores the importance of internal controls and proper documentation of transactions involving 'red flags.'"

- The Cadbury Order simply finds that Cadbury's Indian subsidiary ("Cadbury India") retained an agent to assist with obtaining licenses. Cadbury India did not conduct due diligence on the agent (other than an interview) and the agent billed Cadbury India for assistance in obtaining licenses (applications for which were prepared by Cadbury India's employees). It was further found that Cadbury India paid the agent even though it did not receive documentary support for the agent's services and did not have a written contract at the time of payment.[38]

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34. *Id.* at ¶ 25.
35. *Id.* at ¶¶ 2, 8, 11, 13, 18.
36. *In the Matter of Cadbury Limited and Mondelez International, Inc.*, Order Instituting Cease-and-Desist Proceedings Pursuant to Section 21C of the Securities Exchange Act of 1934, Making Findings, and Imposing a Cease-and-Desist Order, Securities Exchange Act of 1934 Rel. No. 79753, Accounting and Auditing Enforcement Rel. No. 3841, Admin. Proc. File. No. 3-17759 (Jan. 6, 2017).
37. We note that, while it is possible such facts exist and are known to the SEC but not included in the cease-and-desist orders, it is only possible to define the SEC's approach to FCPA enforcement from what the SEC actually chooses to include in its formal orders.
38. *Id.* at ¶¶ 10-12.

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The alleged violation of the accounting provisions was that paying such an agent without due diligence or monitoring "created the risk that funds paid to [the agent] *could be used* for improper or unauthorized purposes."[39]

- The Elbit Order, as it relates to payments relating to the Romania real estate project (which are the only findings implicating foreign bribery), appears similar to the Cadbury Order. The Elbit Order found that Elbit: (i) retained an offshore third party; (ii) in connection with dealings with foreign officials; (iii) in a high risk jurisdiction; and (iv) "the funds *may have been used* to make corrupt payments to Romanian government officials or were embezzled." These are not findings of accounting irregularities or benefits provided to foreign officials, they are merely red flags that "may" or "could" indicate corruption risk.

Both the Cadbury Order and the Elbit Order suggest that failure to conduct due diligence on third parties and the failure to keep sufficient records in the presence of red flags are sufficient findings to support an administrative action for the violation of the books and records and internal controls provisions of the FCPA. As opposed to "virtual strict liability" for the actions of a foreign subsidiary, Cadbury and Elbit create "virtual strict liability" for the *inactions* of a foreign subsidiary.

The Elbit Order goes further than the Cadbury Order. The Cadbury Order affirmatively found that Cadbury India "did not conduct appropriate due diligence on" the agent and "did not receive documentary support for [the agent's] services."[40] The Elbit Order (the earliest activities of which – failure to conduct due diligence on the first consultant – took place twelve years before the Elbit Order was issued) finds that "there is no evidence to suggest" that due diligence was done and that "there is no documentation or other evidence showing" the services rendered by the consultants. In other words, the evidence supporting the SEC's findings is the absence of evidence. This raises the question as to whether the SEC bears any burden of proof in the context of the books and records and internal control provisions.

It is true that approximately $14 million was paid to the consultants relating to Elbit's investment in Romania. And it is perfectly in keeping with the SEC's mission of investor protection to require issuers to keep records and maintain internal controls to ensure that tens of millions of dollars do not leave a corporation without any record of why such payments were made (even if there is no evidence that such payments were improper). It is also true that, had the Elbit Order confined itself to the $12.75 million payment in connection with the US real estate portfolio that ended up in an account beneficially controlled by Executive A (findings which could

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39. *Id.* at ¶ 21 (emphasis added).

40. Cadbury Order at ¶¶ 12, 21.

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form the basis of embezzlement), this could, by itself, justify the cease-and-desist order as well as the relatively small civil penalty. That said, the inclusion of the Romania-related findings raise questions as to how far the SEC is willing to go in policing transactions with the potential for foreign bribery.

To date, the internal controls and books and records provisions have largely been used to "address management misfeasance, misuse of corporate assets and other conduct reflecting adversely on management's integrity."[41] Prior to the Cadbury Order, the SEC included allegations of benefits being provided to foreign officials or accounting irregularities, providing at least an inkling of "misfeasance." The absence of such findings in the Romania sections of the Elbit Order should serve as a general reminder of the importance of record-keeping and internal controls and more specifically should encourage companies to work with counsel to create clear milestones and deliverables for contracts with third parties, which may later serve as evidence that such work by third parties was, in fact, performed. Finally, practitioners and the bar should ask whether it is appropriate for the SEC (or any other enforcement agency) to bring an action under the accounting provisions (or any other provision) based simply on the bare allegation that something untoward "could have" or "may have" occurred. After all, apart from resolving specific misconduct, a Commission Order is supposed to provide guidance to the marketplace through a description of the violation and the legal basis underpinning it. Amorphous descriptions of conduct that "may" or "could" violate the law do not offer clear direction to companies trying to develop a strong compliance program.

Paul R. Berger

Jonathan R. Tuttle

Bruce E. Yannett

Philip Rohlik

Jil Simon

Paul R. Berger is of counsel in the Washington, D.C. office. Jonathan R. Tuttle is a partner in the Washington, D.C. office. Bruce E. Yannett is a partner in the New York office. Philip Rohlik is a counsel in the Shanghai office. Jil Simon is an associate in the Washington, D.C. office. The authors may be reached at prberger@debevoise.com, jrtuttle@debevoise.com, beyannett@debevoise.com, prohlik@debevoise.com, and jsimon@debevoise.com. Full contact details for each author are available at www.debevoise.com.

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41. *World-Wide Coin, supra* note 21, at 748.

China Creates New Anti-Corruption Regulator

On March 20, 2018, China passed a new Supervisory Law,[1] completing the steps necessary to create a new regulatory authority, the Supervisory Commission, with significant anti-corruption oversight responsibilities. Under the law, the Supervisory Commission possesses sweeping powers to investigate and punish disciplinary violations, including corruption, throughout China's Communist Party, state administration, public sector enterprises, and beyond. Like its predecessor, the Communist Party Commission on Discipline and Inspection (the "CDI") – which will continue to act in tandem with the Supervisory Commission – the Supervisory Commission and its provincial and local branches will operate separate from China's court system (over which the Supervisory Commission will have authority), and be subject to the Communist Party's control through the National People's Congress.

The Supervisory Commission's investigative and disciplinary power goes beyond that of the CDI and covers not just Communist Party members, but also anyone falling into the newly introduced category of "public official" (公职人员, *gong zhi ren yuan*).[2] The creation of the Supervisory Commission likely heralds a renewed focus on anti-corruption enforcement in China. By introducing this category of "public official," some forms of bribery of employees of state-owned enterprises (previously dealt with administratively as commercial bribery under China's Anti-Unfair Competition Law[3]) may be subject to the Supervisory Commission's jurisdiction. Further, because the Supervisory Law can be read (and has been applied in a provincial pilot program) as granting the Supervisory Commission jurisdiction over suspected bribe-givers, employees of foreign companies may find themselves subject to detention and investigation by this body.[4] Foreign companies doing business in China therefore should continue enhancing and testing the effectiveness of their anti-corruption controls, out of concern for both the US enforcement of the FCPA and, significantly, local enforcement.

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1. *See* Liangyu, "China's national legislature adopts supervision law," Xinhua Net, (Mar. 20, 2018), http://www.xinhuanet.com/english/2018-03/20/c_137051633.htm.
2. From the language of the laws, the term "public officials" differs slightly from the term "state functionary," as used in the Criminal Law. State functionary refers to all persons engaging in public services in state organs, state owned enterprises, public institutions and organizations, while under the Supervision law, for state-owned enterprises and public institutions, only management therein is defined as public officials. Nevertheless, in practice it is likely that the scope of public officials will be larger than management, making the term public officials an alternative to state functionary.
3. *See* Andrew M. Levine, Kara Brockmeyer, and Philip Rohlik, "China Revises Draft Amendments to Commercial Bribery Legislation," FCPA Update, Vol. 9, No. 3 (Oct. 2018).
4. *See* Tan Chang, "Interview Liu Jianchao, director of the Supervisory Commission of Zhejiang Province," Infzm.com, (Mar. 15, 2018), http://www.infzm.com/content/134252. In this interview, Mr. Liu stated that 100% of "major suspects under investigation" were detained, where he further clarified that "major suspects" referred to public officials. Meanwhile, some bribe givers were also detained.

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The Road to the Supervisory Commission

The standing committee of China's National People's Congress released a draft version of a new Supervision Law (Draft Version, the "**SLD**") in November 2017.[5] The goal of the SLD was to propose the creation of the Supervisory Commission, a new anti-corruption and disciplinary body. At the time the SLD was proposed, pilot programs were rolled out in Beijing municipality and Zhejiang and Shanxi provinces.[6] In February 2018, the standing committee of the National People's Congress proposed a number of amendments to its China's Constitution, including a section formally establishing the Supervisory Commission as a state organ.[7] These amendments to the Constitution were adopted on March 11, 2018. As amended, the Constitution affords the Supervision Commission the status of a "fundamental state organ" governed by the National People's Congress, putting it on the same level as the State Council (the Chinese government, presided over by the Prime Minister), the Supreme People's Court, and the Supreme People's Procuratorate.[8] On March 20, 2018, the National People's Congress passed the final version of the Supervision Law,[9] marking the official creation of China's new super-regulator for anti-corruption and discipline.

China's Old Anti-Corruption Administrative Framework

Until the establishment of the Supervisory Commission, the CDI was the primary entity charged with investigating violations of Communist Party discipline (including, but not limited to corruption). Under President Xi Jinping, the CDI was responsible for China's anti-corruption campaign. The CDI is an organ of the Party (not the government) and has the power to investigate disciplinary violations by Communist Party members. The CDI does not have jurisdiction over Party non-Members. Rather, it shared offices and staff with the Ministry of Supervision, a body under the State Council (the Chinese government headed by the Prime Minister of China), and its local branches (collectively the "Administrative Supervision Authority"), which oversees China's civil service under

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5. Request for Comments on the Supervision Law (Draft) of the People's Republic of China, released on Nov.7, 2017, unofficial translation available at PKU law, http://en.pkulaw.cn/display.aspx?id=9b322d6cadb1245318c1fe0a279380dabdfb&lib=law&SearchKeyword=&SearchCKeyword=%bc%e0%b2%ec%b7%a8.
6. Decision of the Standing Committee of the National People's Congress on Carrying out the Pilot Program of Reforming the National Supervision Mechanism in Beijing Municipality, Shanxi Province, and Zhejiang Province, effective on Dec. 25, 2016, unofficial translation available at PKU law, http://en.pkulaw.cn/display.aspx?cgid=287285&lib=law.
7. *See* Pengying, "China Focus: Proposed constitutional amendment package unveiled," Xinhua Net, (Feb. 25, 2018), http://xinhuanet.com/english/2018-02/25/c_136999410.htm.
8. *See* Lu Hui, "China Focus: China's national legislature adopts landmark constitutional amendment," Xinhua Net, (Mar. 11, 2018), http://www.xinhuanet.com/english/2018-03/11/c_137032165.htm.
9. Supervision Law of the People's Republic of China (the "**Supervision Law**"), effective on Mar. 20, 2018, full text available on http://www.npc.gov.cn/npc/xinwen/2018-03/21/content_2052362.htm (Chinese language only).

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the Civil Servant Law of the People's Republic of China[10] and the Administrative Supervision Law of the People's Republic of China.[11]

The CDI had no law enforcement or prosecutorial authority, although it had the power to compel Communist Party Members to submit to interrogation at a designated time and a designated place, a process called *shuanggui* (meaning "double designation"). A person subject to *Shuanggui* could be held for up to three months, with the possibility of an additional one month extension (or longer), and did not have the types of rights (such as legal representation) associated with police or judicial detention during this period. If the CDI uncovered evidence of wrongdoing, the Party Member could be subject to Party discipline (demotion or expulsion from the Party) and could be handed over to the Public Security Bureau (the police) or the People's Procuraturate (the prosecutor) for prosecution within the Chinese legal system.[12] In October 2017, when the SLD was announced, it was also announced that *Shuanggui* would be abolished.[13]

"Foreign companies doing business in China will want to note the expanded definition of 'public official' and inclusion of 'relevant persons' in the law, as well as the Supervision Commission's possible jurisdiction to investigate non-public officials (such as employees of foreign companies)."

The Supervisory Commission

The Supervisory Commission will be a new fundamental state organ, not subject to oversight by the State Council, the Supreme People's Court, or the Supreme People's Procuratorate. It will be established at each administrative level, from the State Supervisory Commission (at the top of the hierarchy), through the provincial level,

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10. Civil Servant Law of the People's Republic of China, effective on Jan. 1, 2018, unofficial translation available on Westlaw China, http://app.westlawchina.com/maf/china/app/document?&src=nr&docguid=i000000000000015e7567fb10787d03bb&lang=en&crumb-action=append&crumb-label=文件.
11. Administrative Supervision Law of the People's Republic of China, effective on Oct. 1, 2010, unofficial translation available on Westlaw China, http://app.westlawchina.com/maf/china/app/document?&src=nr&docguid=i3cf76ad3000001297ec74f3ae1eff80b&lang=en&crumb-action=append&crumb-label=文件.
12. For a fuller description of the various anti-corruption authorities in China and how the interacted up to the establishment of the Supervisory Commission, *see* Bruce E. Yannett, Sean Hecker, Paul R. Berger, Philip Rohlik and Fengjian Ao, "Spotlight on the Asia-Pacific Region (Part II): Anti-corruption Authorities in China," FCPA Update Vol. 4, No. 2 (Sept. 2012), https://www.debevoise.com/insights/publications/2012/09/fcpa-update.
13. *See* ZD, "Full text of Xi Jinping's report at 19th CPC National Congress," Xinhua Net (Nov. 3, 2017), http://www.xinhuanet.com/english/special/2017-11/03/c_136725942.htm; *see also* Lucy Hornby, "China expands power of anti-corruption watchdog," Financial Times (Oct. 19, 2017), https://www.ft.com/content/156d2d68-b4a4-11e7-a398-73d59db9e399.

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all the way down to the district level of a city.[14] The State Supervisory Commission, consisting of one director, several deputy directors, and several committee members will be appointed by the National People's Congress (China's legislature), and will be monitored by that body.

The director, who will be limited to two terms, is to be directly elected by the National People's Congress. The director will then have the right to appoint or remove deputy directors and committee members subject to approval by the Standing Committee of the National People's Congress[15] (the Standing Committee is a subset of the National People's Congress and exercises day-to-day legislative power under China's constitution).

The process established for staffing and oversight of the Supervisory Commission is identical to the process used for electing judges of the Supreme People's Court and for prosecutors of the Supreme People's Procuratorate, which demonstrates the similarity of the State Supervisory Commission's status to those two organs. Supervisory Commissions at lower levels will be generated in the same manner (i.e., appointment and oversight by the provincial, municipal or district People's Congress and their standing committees, respectively).[16] It will share staff with and work alongside the CDI, which will continue to exercise a disciplinary role within the Party.

The CDI has jurisdiction over only Communist Party members. While Party members occupy leading roles in the government, bureaucracy, civil service, and management of state-owned enterprises, not all civil servants and state-owned enterprise managers in China are Party members. The Supervisory Commissions are authorized to conduct supervision, investigation, and discipline over all "public officials" – a new term introduced in the Supervision Law, but not used in the relevant anti-corruption provisions of the Criminal Law. The Supervision Law defines "public officials" in a non-exclusive list to include:

- Public servants in
  - Communist Party's organs;
  - People's Congresses and their standing committees;
  - People's Government;
  - Supervisory commissions;
  - People's Courts (i.e., the judiciary);
  - People's Procuratotrates (i.e., prosecutors);
  - People's Political Consultative Conference organs;

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14. The Supervision Law, Art. 7.
15. *Id.* Art. 8.
16. *Id.* Art. 9.

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  - Other political parties' organs;
  - Federation of Industry and Commerce's organs; and
  - Other persons governed by the Civil Servant Law;
- Any person engaged in public service in organizations authorized by laws to manage public affairs;
- Management in state owned enterprises;
- Management in public funded educational, science, medical, sporting and cultural institutions;
- Management in fundamental autonomous organizations; and
- All other persons acting as public officials.[17]

When a public official violates a law or commits a crime in the performance of his duty, such as, for example, accepting bribes, a relevant Supervisory Commission may investigate his or her wrongdoing. Compared to previous versions, the final version of the Supervision Law provides for broader jurisdiction of the Supervisory Commissions, including both "public officials" and "relevant persons," the definition of which is not clearly provided.[18]

Supervisory commissions are entitled to use investigative methods resembling those used by a public security bureau (the police). For example, the commissions have powers of inquiry, detention ("*liuzhi*"), search, seizure, and examination.[19] Although the Supervisory Commission acts separate and apart from China's legal system (i.e., police, prosecutors, and courts) the Supervision Law marks the first time China has provided a legal basis for extra-judicial detention in a corruption investigation. China's Legislation Law provides that any measures restricting the freedom of a person must be established by law and the CDI's *shuanggui* system was often informally criticized as violating the Legislation Law.[20] Under the Supervision Law, the supervisory commission may detain a suspect in a specific place, subject to approval by or notification of a higher Supervisory Commission if:

- A person is suspected of a serious violation of law or crime;
- The Supervisory Commission already has certain evidence thereof; and

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17. *Id.* Art. 15.
18. *Id.*
19. *Id.* Art. 18-30.
20. The Legislation Law of the People's Republic of China, effective on Mar. 15, 2015, unofficial translation available at Westlaw China, http://app.westlawchina.com/maf/china/app/document?&src=nr&docguid=i3cf76ad10000014c20983ba61082ea37&lang=en&crumb-action=append&crumb-label=文件, Art. 8.

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- One of the following circumstances is met:
  - the case involved is complex;
  - the suspect may flee or commit a suicide;
  - the suspect may collude with others, or forge, destroy, conceal evidence; or
  - the suspect may engage in other conduct that will interfere the investigation, then.[21]

Generally, detention shall not exceed three months, but under specific circumstances it can be extended for up to an additional three months if approved by a Supervisory Commission of a higher level.[22]

After the investigation, a Supervisory Commission may impose one of the following punishments depending on the facts and severity of the case:

- Disciplinary punishments, such as formal warnings, demotion, or dismissal;
- Reprimands ("advice") to the relevant unit in which the suspect works;
- A finding of dereliction with regard to the disciplinary controls of the suspect's superiors ("*wenze*"); or
- Referral to the People's Procuratorate.[23]

The Supervisory Commission will investigate criminal activity and/or refer a case to the procuraturate – the role usually carried out by the Public Security Bureau (or police department). However, given that the Supervisory Commission's constitutional status will be equal or superior to the judicial and prosecutorial authorities, it is unclear whether a suspect's right to a lawyer will attach to Supervisory Commission investigations and what recourse a suspect will have while in custody. Rights of criminal defendants are provided for in the Criminal Procedure Law, but the Supervision Law is silent on the issue. It may be that a suspect will be entitled to a lawyer only after the case is referred to the People's Procuraturate, but the rights a suspect has while under investigation by the Supervisory Commission remain an open question.

After its establishment, the Supervisory Commission will play a leading role in China's anti-corruption campaign. However, the Supervision Law remains obscure on many key issues. In addition to what rights a suspect will have, questions remain as to how the Supervisory Commission will coordinate with the police department,

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21. The Supervision Law, Art. 22.
22. *Id.* Art. 43.
23. *Id.* Art. 45.

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prosecutorial authorities, and courts, as well as the continuing role of the CDI. Moreover, although theoretically the Supervisory Commission system only has jurisdiction over "public officials," the Supervision Law's provisions relating to investigation and detention also apply to bribe givers, regardless of whether they are public officials.[24] It is therefore possible that persons who are not "public officials" will be subject to its jurisdiction.

The Supervision Law represents a new stage of China's anti-corruption campaign. Foreign companies doing business in China will want to note the expanded definition of "public official" and inclusion of "relevant persons" in the law, as well as the Supervision Commission's possible jurisdiction to investigate non-public officials (such as employees of foreign companies). Even more so than is already the case, foreign companies operating in China should be cautious when dealing with public officials, not simply because of potential FCPA liability, but also because of local enforcement risk.

Kara Brockmeyer

Andrew M. Levine

Philip Rohlik

De Zha

Kara Brockmeyer is a partner in the Washington, D.C. office. Andrew M. Levine is a partner in the New York office. Philip Rohlik is a counsel, and De Zha is a consultant, both in the Shanghai office. The authors may be reached at kbrockmeyer@debevoise.com, amlevine@debevoise.com, prohlik@debevoise.com, and dzha@debevoise.com. Full contact details for each author are available at www.debevoise.com.

24. *Id.* Art. 224 ("For a person suspected of giving bribery or being an accomplice in a crime related to official duties, the Supervisory Commission may apply the detention measure thereto.").

FCPA Update

FCPA Update is a publication of
Debevoise & Plimpton LLP

919 Third Avenue
New York, New York 10022
+1 212 909 6000
www.debevoise.com

Washington, D.C.
+1 202 383 8000

London
+44 20 7786 9000

Paris
+33 1 40 73 12 12

Frankfurt
+49 69 2097 5000

Moscow
+7 495 956 3858

Hong Kong
+852 2160 9800

Shanghai
+86 21 5047 1800

Tokyo
+81 3 4570 6680

Bruce E. Yannett
Co-Editor-in-Chief
+1 212 909 6495
beyannett@debevoise.com

Andrew J. Ceresney
Co-Editor-in-Chief
+1 212 909 6947
aceresney@debevoise.com

Andrew M. Levine
Co-Editor-in-Chief
+1 212 909 6069
amlevine@debevoise.com

Karolos Seeger
Co-Editor-in-Chief
+44 20 7786 9042
kseeger@debevoise.com

Erich O. Grosz
Co-Managing Editor
+1 212 909 6808
eogrosz@debevoise.com

Jil Simon
Associate Editor
+1 202 383 8227
jsimon@debevoise.com

Kara Brockmeyer
Co-Editor-in-Chief
+1 202 383 8120
kbrockmeyer@debevoise.com

Sean Hecker
Co-Editor-in-Chief
+1 212 909 6052
shecker@debevoise.com

David A. O'Neil
Co-Editor-in-Chief
+1 202 383 8040
daoneil@debevoise.com

Jane Shvets
Co-Editor-in-Chief
+44 20 7786 9163
jshvets@debevoise.com

Philip Rohlik
Co-Executive Editor
+852 2160 9856
prohlik@debevoise.com

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