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Salespeople Get Caught In SEC's Governance Net

GCs Need To Examine Sales Practices To Ensure Compliance

BY MICHAEL T. BURR

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—Robert Benowitz
Partner
Rick, Steiner, Fell & Benowitz

WHEN ONE of John K. Adams' biggest customers called in April 2002 asking for a favor, the regional sales manager for Kraft Foods Inc. agreed to help. After all, the customer's request seemed harmless and would cost Adams nothing more than his signature on a letter.

The letter Adams signed characterized certain payments from Kraft to the customer—the now-bankrupt food-industry giant the Fleming Cos.—as payments to cover a "shortfall" in past accounts. Adams didn't think he had any reason to worry—he had signed a similar letter in December 2001 and nothing came of it.

That changed five months later, however, when the Wall Street Journal published a story alleging improprieties in Fleming's dealings with vendors ("Grocery distributor squeezes suppliers at bill-paying time," WSJ, Sept. 5, 2002). The SEC initiated an investigation in November 2002, and soon Kraft and several of Fleming's other vendors—including Frito Lay, Kemps and Dean Foods—found themselves in the midst of an accounting scandal.

"It takes two to tango," said Spencer C. Barasch, an associate administrator with the SEC in a September 2004 statement. "Without suppliers providing or agreeing to false transaction documents, Fleming could not have misled investors as it did."

Ethics breaches in sales operations are hardly unique to the Fleming case.

In April 2003, salespeople at Sara Lee and ConAgra Foods signed misleading "side letters" that helped Royal Ahold's U.S. foodservice unit perpetrate frauds that ultimately cost investors $6 billion. And sales shenanigans aren't restricted to the food business. Salespeople have been implicated in financial-reporting scandals at Citibank, Qwest, Gemstar, Broadvision and EasyLink.

Additionally, more scandals of this type likely will emerge in the near future. "A number of cases are in the pipeline now, and the SEC will continue bringing cases against salespeople," says David Bayless, a partner with Morrison & Foerster in San Francisco, and formerly district administrator for the SEC's San Francisco office. "The SEC's enforcement division is getting more aggressive, and this is another example. Regulators want to enlarge the circle of potential liability, to put the fear of God into more people."

The prospect of an increase in such cases raises troubling questions about sales practices, internal controls and cultural norms at U.S. corporations. Yet despite all the governance-reform measures that companies have undertaken in recent years, sales processes have received minimal attention from legal departments. Given the requirements of Sarbanes-Oxley and the new federal sentencing guidelines, in-house counsel can scarcely afford to ignore sales practices in their compliance efforts.

"Salespeople are dancing in the spot where there's the greatest likelihood for unethical behavior, because of the incentives and rewards in the process," says Carlo di Florio, a director with PricewaterhouseCoopers' governance risk management and compliance practice in New York. "Companies have engaged in a tremendous amount of effort to improve their processes around good governance. But it's tough to know whether companies have plugged this particular gap, because such cases continue to arise."

Too Much Slack

Plugging the sales-ethics gap means more than simply changing processes. In many cases, it requires substantive changes in management practices, compensation policies and cultural factors that strongly affect a company's sales strategy, as well as how salespeople execute that strategy.

Companies' recent brushes with regulators amply demonstrate the need for a seismic shift. In a growing list of cases, regulators are probing not only specific instances of corporate fraud and malfeasance, but also are asking questions about the internal controls and processes that should prevent such violations.

"In many cases the SEC is taking a hardline approach," says Robert Benowitz, a partner with Rick, Steiner, Fell & Benowitz in New York. "They are focusing now on the letter and spirit of the law, rather than

whether someone was actually defrauded or securities were affected. And they are going down into the bowels of companies and naming salespeople in investigations."

These SEC investigations take a critical look at companies' internal controls and policies. "When the SEC brings someone in to testify under oath, they will ask about specific events, but they definitely will ask larger corporate-culture questions as well," Bayless says. "They want to understand whether this is an isolated event or a systemic problem."

Such a systemic problem might be management's outright complicity with fraudulent sales practices, or simply a failure to properly educate salespeople and monitor their activities. "The SEC is asking people whether they've received training on booking sales and recording transactions, and often the answer is, 'No, we leave that to the company's financial accounting department,'" Benowitz says.

This lax attitude opens the door to compliance breaches as aggressive salespeople strive to meet quarterly goals. For instance, the SEC censured two former Qwest sales executives in October 2004 for circumventing accounting standards with side agreements that allowed customers to "port" their network-capacity rights before paying for them. Those agreements let Qwest book more than $25 million in up-front revenue for sales it should have recognized over several quarters.

In other cases, the SEC has cited salespeople for booking revenue for sales they hadn't finalized or had contingencies attached to them (see *SEC v. Robert Asti;* and *SEC v. Peter J. Webb*). Many such cases involve deals that occurred in the late 1990s and early 2000s, but some companies still have not taken adequate steps to bring their salespeople up to speed on compliance obligations. Regulators are poised to pounce on unwary companies.

"If you went out and canvassed senior salespeople at large companies, you'd find many are not aware of the potential impact the rules have on them," Benowitz says. "But companies cannot plead ignorance on Sarbanes-Oxley and Financial Accounting Standards Board revenue-recognition policies."

The practices that put companies at risk are surprisingly routine. For example, companies and salespeople might find themselves in the SEC's crosshairs for violations involving such common events as sales contracts being amended in ways that change revenue-recognition conditions.

"A contract amendment is not improper in itself, but it might have financial-reporting implications," Bayless says. "The SEC assumes salespeople have a certain amount of knowledge about financial reporting, and that assumption is often wrong."

Nevertheless, companies bear the burden of educating salespeople and implementing adequate internal controls—such as procedures and responsibilities for reviewing and monitoring transactions, training sales staff about financial reporting and promoting open communications between salespeople, managers and compliance officers.

"Companies are geared toward meeting quarterly revenue projections and sales quotas. It can be difficult to police sales practices," Benowitz says. "But people need to be educated about the requirements and potential liabilities in connection with revenue recognition and sales practices. If people engaged in selling activities are apprised of the potential issues for them personally, they'll take a stronger role in making sure things are done in accordance with the rules."

Indeed, experience seems to show that when salespeople are aware they are subject to scrutiny, they are more likely to behave ethically.

"Give someone rope, and they can always use it to hang themselves," says a senior sales manager for a major pharmaceutical company, who spoke on condition of anonymity. "But right now the rope is really short, and monitoring is extremely high."

For example, at this sales manager's company, salespeople enter their activities into a daily tracking system, and any new promotion or tactic goes through exhaustive legal and accounting review before staff can implement it in the field.

"The last I heard, 62 different signatures were required to get anything new through the system," he says. "That's not required by the federal government or the PhRMA code of conduct, but is something the company does because they don't like lawsuits. Sometimes it seems like overkill, but ultimately it's a good thing if you want to live to breathe another day."

Cultural Revolution

Ultimately, a company's stated policies and procedures represent only part of its overall

SEC Point-of-Sale Rules In Flux

Regulators have been shining a bright light on sales practices lately. But rather than focusing on revenue-recognition issues, most of this light has shone on point-of-sale disclosure practices in the financial industry.

Last year, the NASD filed rule changes to standardize the way investment brokers and dealers communicate information about fees, expenses and performance. Concurrently, the SEC proposed new rules governing what salespeople must tell clients investing in mutual funds, college savings plans and variable insurance products.

The changes are part of a broader crackdown to force securities dealers to make more transparent disclosures of costs, fees and conflicts of interest, and to make it easier for buyers to understand and compare the performance of various products.

The SEC has been working on its proposed rules for more than a year, and taken considerable flak from financial institutions and investor groups during that time. As a result, the agency issued proposed amendments in January 2005 and sought further comments on numerous questions—from the design of disclosure forms to definitions and exceptions.

Despite making significant changes (and even expanding the scope of some disclosure requirements) the SEC reopened the comment period for only an additional month, from March 1 through April 4. This abbreviated period might indicate the commission is close to issuing final rules on point-of-sale disclosures. If so, financial institutions and investment brokers soon will be reprinting reams of literature and forms, and retraining their sales and marketing organizations to ensure compliance with the new requirements.

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ethics profile. Corporate culture might outweigh the nuts and bolts of compliance when it comes to ensuring salespeople adhere to ethical practices.

"We are a rule-of-law society, and people tend to ask what they can and can't do, as opposed to what they should and shouldn't do," says Dov Seidman, CEO of LRN, a Los Angeles-based company that develops interactive learning systems for corporate compliance and ethics. "Now we are seeing a profound shift toward the principle of fair dealing and a culture of ethics. It's no longer enough to be technically in accord with a set of rules."

Seidman notes that the word "culture" is specifically used in the organizational sentencing guidelines promulgated last year by the U.S. Sentencing Commission, as well as the Justice Department's standards of prosecution. A company must demonstrate efforts to encourage ethical behavior throughout its culture, including the sales organization.

"The first thing for executives to realize is there isn't just one lever to pull to move your culture," he says. "There are too many gaps between rules and fairness in human conduct."

As a result, general counsel might find promoting ethical sales practices more difficult than instituting cut-and-dry accounting standards. Beyond the legality of conduct, a culture of ethics demands fair play and honesty across a wide spectrum of business practices.

"At the high level, it is more of a cultural issue than a process issue," di Florio says. "But it gets quickly to processes. You have to ask questions about the processes for defining the organization's values, policies and procedures, as well as processes for training and communicating those values, monitoring and investigating performance, and reinforcing the culture with incentives and disciplinary actions."

Developing appropriate incentives might be one of the most difficult aspects of ensuring ethical sales practices. Most corporations compensate salespeople for their sales performance, not their ethics, and that creates a conflict that many companies might find difficult to resolve. At the same time, the implications of regulatory scrutiny and enforcement might be adequate in themselves to encourage higher ethical standards among sales organizations.

"If you are caught doing the wrong thing and putting the company at risk, you will lose your job and you won't get another one in the industry," says the pharmaceutical sales manager. "That's what I call an incentive program."

The SEC is turning its attention to sales practices that affect companies' revenue recognition and point-of-sale disclosures, leaving in-house counsel scrambling to get salespeople up to speed on the latest regulations.

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