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Eletrobras Settles Alleged FCPA Violations Revealed Through Brazil's "Operation Car Wash"

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Anti-Corruption/FCPA

On December 26, 2018, the U.S. Securities and Exchange Commission ("SEC") settled an enforcement action against Centrais Eléctricas Brasileiras S.A. ("Eletrobras"), an electric utilities holding company majority-owned and controlled by the Brazilian government. This is the second time in 2018 in which the United States government charged a Brazilian state-owned entity with violating the books and records and internal accounting controls provisions of the Foreign Corrupt Practices Act ("FCPA"). As with the September 2018 settlement with Petróleo Brasileiro S.A. ("Petrobras"), the alleged corruption scheme at an Eletrobras subsidiary was uncovered as part of the larger Operation Car Wash ("*Lava Jato*") in Brazil. Petrobras's settlement, however, involved a coordinated resolution with the U.S. Department of Justice ("DOJ"), the SEC, and the Brazilian Federal Public Ministry ("MPF").

In particular, the Eletrobras enforcement action was based on allegations that spanned from 2009 to 2015, former officers at Eletrobras's majority-owned nuclear power generation subsidiary, Eletrobras Termonuclear ("Eletronuclear"), inflated the costs of infrastructure projects and authorized the hiring of unnecessary contractors. In return, the former officers allegedly received approximately $9 million from construction companies that benefitted from the corrupt scheme. The construction companies also used the overpayment to fund bribes to leaders of Brazil's two largest political parties. The SEC alleged that Eletrobras violated the FCPA by recording inflated contract prices and sham invoices in Eletrobras's books and records, and by failing to devise and maintain a sufficient system of internal accounting controls. Without admitting or denying the findings, Eletrobras agreed to the entry of a cease-and-desist order and agreed to pay a $2.5 million civil penalty.

Although Eletrobras had been under DOJ investigation, it announced in an August 2018 securities filing that the DOJ had declined prosecution. Eletrobras also entered into a memorandum of understanding with holders of its American depository shares and agreed to pay investors $14.75 million to settle a class action lawsuit related to the alleged misconduct. The U.S. District Court for the Southern District of New York approved the class action settlement a few days before to SEC announced its FCPA settlement with Eletrobras.

In Brazil, prosecutors have arrested at least 19 individuals in connection with an investigation into the alleged Eletronuclear scheme. In 2016, Eletronuclear's former president was convicted of corruption, money laundering, organized crime, and obstruction of justice, and sentenced to 43 years in prison. In addition, in 2017, Brazil's Federal Court of Accounts (Tribunal de Contas da União, "TCU") barred, for a five-year period, several engineering firms from bidding on public works contracts in connection with their involvement in the alleged scheme.

Background and Alleged Misconduct

According to the SEC's administrative order, the alleged bid-rigging and bribery scheme began in 2009, when Eletronuclear began renegotiating, and ultimately executed, an approximately $4.9 billion construction contract for a nuclear power plant ("UTN Angra III"). The alleged scheme also involved the awarding of a second, approximately $1.1 billion contract, for electromechanical assembly services in 2014. The SEC alleged that Eletronuclear officers, including the company's former president, used their influence over the prequalification, budgeting, and procurement processes associated with the UTN Angra III contracts to authorize unnecessary contracts and inflate the costs of the projects to the benefit of several Brazilian construction companies. In return, the former Eletronuclear president allegedly received approximately $4.1 million, and other former Eletronuclear officers received an additional $4.9 million. The SEC also alleged that construction company executives used the funds that they received from the inflated contracts and sham invoices to pay the bribes of the Eletronuclear executives, and direct a total of 2% of the UTN Angra III contracts to government officials associated with two of Brazil's largest political parties.

Books and Records Violations

The SEC alleged that Eletrobras violated the books and records provision of the FCPA (Section 13(b)(2)(A) of the Exchange Act) because its subsidiary Eletronuclear recorded the inflated contract prices and sham invoices used in the bribery scheme as legitimate expenses for goods or services, and those expenses were consolidated into Eletrobras's financial statements.

Internal Accounting Controls Violations

The SEC alleged that Eletrobras violated the internal accounting controls provision of the FCPA (Section 13(b)(2)(B) of the Exchange Act) by "failing to devise and maintain a sufficient system of internal accounting controls." The SEC identified several examples of insufficient and ineffective compliance policies and internal accounting controls:

- The Eletrobras code of ethics, adopted in 2005, only applied to the holding company, not to the company's various subsidiaries and special purpose entities.
- Eletrobras's anti-corruption policies, procedures, and accounting controls contained "general or boilerplate prohibitions" that either did not apply to all employees or were simply ignored. For example, the code of conduct adopted for subsidiaries in 2010 contained a prohibition on contributions to political parties and campaigns, and also required the selection and hiring of suppliers based on specific criteria including legal, technical, quality, cost and timeliness. However, the company's accounting controls designed to promote these ethical principles—including contractual measurement criteria requiring that payments to suppliers be proportional to the worked performed—were ignored or circumvented.
- Eletrobras's compliance policies and procedures "were not specifically tailored to the inherent risks associated with Eletrobras's business operations."
- Eletrobras's annual reports over a six-year period disclosed "significant material weaknesses in Eletrobras's internal control over financial reporting that were not remediated for many years," and "[m]any of these material weaknesses, including the failure to maintain effective controls to ensure the completeness, accuracy, validity, and

valuation over the purchase and payments of goods and services, contributed to the bribery scheme flourishing undetected for years."

Remedial Efforts and Cooperation Credit

In its Order, the SEC highlighted the Company's cooperation with the SEC in its investigation and the company's remedial efforts. The SEC noted that the company's remediation included "disciplining employees involved in the misconduct, enhancing its internal accounting controls and compliance functions, remediating material weaknesses identified in its annual reports with the Commission, and adopting a new anti-corruption policies and procedures."

Observations and Lessons Learned

Insufficient Compliance Policies and Procedures

This enforcement action highlights the SEC's continued focus on the creation, implementation, and maintenance of effective compliance programs. The SEC's finding that Eletrobras failed to maintain compliance policies and procedures that were specifically tailored to the inherent risks associated with the operation of Eletronuclear serves as a useful reminder for compliance personnel at parent organizations that it is not sufficient to establish or maintain perfunctory compliance programs. Rather, individualized and effective compliance policies and procedures need to be developed to address the specific risks faced by the company and/or its subsidiaries. Furthermore, an effective compliance program must be rolled-out at all levels of the corporate organization, including subsidiaries. Finally, it is critical for public companies to swiftly address identified weaknesses in their internal controls over financial reporting.

Comparing Petrobras and Eletrobras

Both the Petrobras and Eletrobras enforcement actions are based on books and records and internal controls violations stemming from a bribery and kickback scheme that benefited not only company employees (themselves "foreign officials" under the FCPA) but also Brazilian politicians. Neither company was charged with violating the FCPA's anti-bribery provisions, suggesting it is possible that U.S. authorities lacked either a jurisdictional nexus necessary to pursue anti-bribery charges against these foreign "issuers" or sufficient evidence indicating that the improper payments to the Brazilian politicians were given "for purposes of obtaining or retaining business" for each company.

Both enforcement actions are unusual because they target foreign state-owned entities—Statoil ASA is the only other foreign state-owned entity ever charged with violations of the FCPA—and because the companies were victims of an employee kickback scheme at the same time they were facilitators of bribes to foreign government officials. In the Petrobras press release and non-prosecution agreement ("NPA"), DOJ specifically pointed to the status of the company and its shareholders as victims as one of the mitigating factors that led to this resolution despite significant misconduct by the entity.

By all accounts, the Eletrobras settlement is small given the size of the alleged scheme and the prominent role of top executives. Moreover, while Petrobras entered into coordinated resolutions with DOJ, the SEC, and the MPF, Eletrobras only entered into a settlement with the SEC. DOJ declined to prosecute Eletrobras, and it appears that Brazilian authorities are focused primarily on prosecuting Eletrobras's former executives.

In both settlements, U.S. enforcement authorities did not require an independent compliance monitor despite the expansive nature of the alleged corrupt schemes. In its NPA with Petrobras, DOJ noted that it determined a monitor was not required because of the company's remediation, the state of its compliance program, the company's agreement to report to DOJ on its compliance program for a period of three years, and the fact that the company would be subject to oversight by Brazilian authorities.

Both cases arise from Operation Car Wash, where Brazilian and U.S. authorities have jointly investigated and prosecuted different aspects and targets that have unfolded from the Operation. The unusual aspects of these resolutions likely reflect both the unique circumstances of Operation Car Wash and the status of the companies as foreign state-owned entities.

Both Petrobras and Eletrobras also faced class action lawsuits by investors based on their alleged misconduct that were settled shortly before each company's respective resolutions with U.S. authorities. However, the companies' investor settlements were accounted for differently by the SEC. In Petrobras, the SEC agreed to reduce the imposed disgorgement amount by any amount paid to the class action settlement fund. In Eletrobras, which only had a civil penalty and no disgorgement, the SEC did not agree to reduce the relatively low $2.5 million civil penalty by the amount paid in the class action.

If you have any questions concerning the material discussed in this client alert, please contact the following members of our Anti-Corruption/FCPA practice:

Lanny Breuer	+1 202 662 5674	lbreuer@cov.com
Veronica Yepez	+1 202 662 5165	vyepez@cov.com
Jennifer Saperstein	+1 202 662 5682	jsaperstein@cov.com
Gerald Hodgkins	+1 202 662 5263	ghodgkins@cov.com
Ashley Sprague	+1 202 662 5604	asprague@cov.com
Joshua González	+1 415 591 7062	jgonzalez@cov.com
Mary Hernandez	+1 202 662 5022	mhernandez@cov.com

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