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ALM

‘Mod’ to ‘SOX’ to ‘ISA’

Enhanced Customs Compliance Under Sarbanes-Oxley

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Almost 10 years before the enactment of the Sarbanes-Oxley Act of 2002 (hereinafter SOX), the U.S. Customs Service, now U.S. Customs and Border Protection (CBP), persuaded Congress to enact legislation to mandate many of the same corporate compliance guidelines that are now prevalent under SOX. That law, the Customs Modernization and Informed Compliance Act (Mod Act), Pub. L. 103-182, became effective Dec. 8, 1993.

CHANGES BROUGHT BY THE CUSTOMS MODERNIZATION ACT

Prompted by the dual dilemmas of rapidly increasing importations, which were expected to double over a 10-year period, and pressure to contain the costs of adding personnel to staff the burden of increased import traffic, Customs perceived that the way to help alleviate the impending crisis was to automate its commercial operations. Traditionally, the Customs Service had monitored import compliance, primarily by examining paperwork known as

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“entry” documentation. Under this tedious and time-consuming “green eyeshade” approach, Customs import specialists, auditors and other Customs officials reviewed documentation filed by customs brokers on behalf of their importer customers at the time a shipment arrived in the United States, in an attempt to determine whether an importer was paying the proper amount of duty to the government and obeying all other customs laws.

Knowing that this method of operation was antiquated and desiring to prepare for a new century in which electronic documentation generated by most importers would leave Customs' compliance oversight structure in danger of becoming a dinosaur, the agency proposed the Mod Act (part of the same legislation that implemented The North American Free Trade Agreement (NAFTA)). The Mod Act, the foundation for Customs' current compliance and law enforcement efforts, fundamentally changed the nature of compliance by shifting the responsibilities for tariff classification, valuation and other customs requirements to the importer. Concurrently, the Mod Act created new record-keeping requirements and severe penalties for those importers that failed to produce records when required by Customs (The so-called (a)(1)(A) list: 19 U.S.C. 1509(a)(1)(A)). In short, the Mod Act forever changed the “green eyeshade” approach to customs compliance. In the Mod Act world, the emphasis is on post-entry compliance scrutiny, with importers

typically facing audits covering transactions occurring years prior to an audit.

THE MOD ACT

Prior to the Mod Act, a customs audit, which might lead to duty exposure and civil or criminal penalties, was structured in a “hit-and-run” fashion. Customs would concentrate on leveraging its law enforcement activities to extract the maximum revenue and penalty recovery from an importer. Customs gave little, if any, thought to an importer devising remedial measures to attempt to ensure that the same or similar violations would not occur after Customs' enforcement measures were imposed and officials went on to audit the next importer.

Under the Mod Act's shared responsibility principles, however, it was anticipated that importers would establish internal controls and retain records which Customs could access in an electronic entry filing context. Such measures, Customs optimistically anticipated, would include the implementation of compliance systems to alleviate the repetitious nature of compliance errors that Customs correctly perceived were rampant in the import community. Customs hoped that the implementation of such internal controls by importers would facilitate corporate customs compliance and help alleviate the shortage of Customs officials dedicated to enforcement efforts (The current Customs' audit program, the “Focused Assessment,” is supposed to concentrate on a corporation's internal compliance

systems, rather than to merely generate revenue, in the form of duties and penalties).

Reasonable Care

In order to illustrate compliance standards under the Mod Act, Customs established "reasonable care" standards for importers and published a list of "reasonable care guidelines," which provided examples of what constitutes the exercise of reasonable care. The failure of an importer to exercise such standards would be grounds for Customs to impose civil penalties against the importer, or anyone who aided or abetted the importer, under 19 U.S.C. 1592.

Among the reasonable care guidelines established by Customs was the proposition that an importer who relied on the advice of an outside customs expert, such as a customs broker, attorney, accountant or other consultant retained by the importer for the purpose of resolving a particular customs issue, would be considered evidence of good compliance. Customs' reasonable care guidelines, however, caution that an importer who relies on the advice of an outside consultant does so at its own peril, in the event that the importer chooses a consultant whose expertise is not in the area for which he or she was consulted. For example, an importer who engages a former Customs inspector, whose responsibilities entailed the physical examination of imported merchandise, would not be a suitable expert to consult on a complex customs valuation issue. Additionally, the exercise of reasonable care through use of an outside expert could be used only as a defense to the imposition of penalties against the importer. In other words, although acting in accordance with an expert's advice might preclude Customs from imposing a penalty against the importer for violation of the civil penalty statute, or serve to mitigate any penalty ultimately imposed, it would not relieve the importer from having to pay additional duties in the event that Customs disagreed with the outside expert's advice.

SOX PRINCIPLES MIRROR CUSTOMS' COMPLIANCE PROGRAM

Under SOX, companies are obligat-

ed to establish standards to ensure compliance with legal and ethical standards, including implementing and maintaining internal compliance programs. SOX mandates that companies evaluate their internal controls using "suitable criteria." A methodology for implementing such internal controls was developed by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). The COSO framework specifies five criteria that are necessary to create a successful internal control program:

- **Control Environment.** The control environment sets the tone of an organization, influencing the control consciousness of its people.
- **Risk Assessment.** Every entity faces a variety of risks from external and internal sources that must assess both the entity and the activity level.
- **Control Activities.** These policies and procedures help ensure management directives are carried out.
- **Information and Communication.** Pertinent information must be identified, captured and communicated in a form and timeframe that supports all other control components.
- **Monitoring.** Internal control systems need to be monitored — a process that assesses the quality the system's performance over time.

Customs, in the aftermath of 9/11, accelerated the development of a corporate compliance monitoring system that mirrors the COSO framework (Although Customs' ISA program was developed independently of COSO). Because the restructuring of Customs as part of the Department of Homeland Security changed its primary focus to antiterrorist activities, Customs' already sparse commercial compliance resources were further strained. For example, Customs special agents who, in a pre-9/11 world, devoted a large portion of their time to commercial enforcement were shifted to another branch of Homeland Security, Immigration and Customs Enforcement (ICE). ICE's focus was on securing U.S. borders against terrorism, and customs commercial enforcement for this new agency became a distant, secondary concern.

Other Customs' employees, although still devoted primarily to commercial enforcement, were nevertheless mandated by CBP upper management to become part of the border security team. Thus, many CBP auditors, who were instrumental in working with Customs special agents and other government officials in prosecuting civil and criminal violations, were reassigned to investigating money laundering as part of the antiterrorism mandate.

Such factors contributed to the establishment of a new Customs program that would help alleviate the workload of auditors. The new program, first announced to the importing community in June 2002, allowed importers to assume responsibility for self-assessment of their own import compliance in exchange for agreed upon benefits and less CBP oversight.

THE BIRTH OF ISA

The new program, coined by Customs as the Importer Self-Assessment (ISA), was voluntary. A prerequisite for admission to ISA was membership in C-TPAT (Customs-Trade Partnership Against Terrorism). While C-TPAT was concerned with security and not commercial compliance, Customs used ISA as a carrot for C-TPAT membership, again stressing Customs' new primary focus on antiterrorism. Customs had previously tried to entice importers into another internal compliance program, the Importer Compliance Monitoring Program (ICMP). ICMP, however, failed miserably because of the lack of benefits available to importers who volunteered for the program.

Although not modeled on SOX's COSO framework, ISA accomplishes the same goals in an import compliance context. To be admitted to ISA, an importer must commit to Customs that it will:

- Establish, document, and implement internal compliance controls;
- Perform periodic testing of transactions based on risk;
- Maintain results of testing for three years and make such test information available to CBP when so requested;

- Make appropriate adjustments to internal controls; and
- Maintain an audit trail from financial records to CBP entry declarations.

Additionally, an ISA member must disclose to Customs any violation of customs law discovered during the course of its internal reviews and submit an annual written notification to CBP confirming that the importer continues to meet ISA program requirements. Importers may meet ISA program requirements by using either internal resources or an outside objective source to make sure the importer is exercising due diligence and reasonable care.

Unlike the now defunct ICMP program, ISA benefits are significant. Among the more important ones are:

- Multiple corporate business units can be covered;
- The importer will have free access to entry summary trade data, including Customs' analysis support;
- If civil penalties or liquidated damages are assessed against the importer, ISA membership will be considered a significant mitigating factor, thereby reducing the importer's penalty or liquidated damages liability;

If CBP discovers a non-fraudulent compliance violation of an ISA member, CBP will provide a written notice to the importer and provide the importer the opportunity to file a prior disclosure to eliminate its penalty liability; and

Most importantly, the importer will be exempt from any general customs audit.

As of this writing, only a relative handful of importers have taken advantage of the ISA (Although relatively few in absolute numbers, Customs claims that current ISA applicant's shipments comprise 17% of the value of imported merchandise). Initially, there was perception among many importers that the ISA program was a trap, set by Customs to obtain admission into an importer's premises and access to its records for the purpose of assessing underpaid duties and penalties while Customs was conducting a verification of the importer's ISA commitment (Our firm's experience representing importers in

the ISA process, however, is contrary to this perception). In addition, many importers were reluctant to volunteer for a program in which the primary benefit was to render them audit-free, without certainty that they would be audited by Customs. Such importers, therefore, chose to "roll the dice," hoping that Customs would not slate their company for an audit.

SOX BECOMES A CATALYST FOR MOD ACT COMPLIANCE

Although the Mod Act is over a decade old and Customs has sought, through its "informed compliance" outreach initiatives, to stimulate importers' awareness of their reasonable care requirements and the sanctions which would be imposed for an importer's failure to comply with such standards, the Mod Act still has a long way to go to achieve the results Customs had hoped. Up until a few years ago, it was my experience that the vast majority of importers failed to focus on customs compliance. In fact, customs compliance was relegated to the "back seat" by most large importers, which were either not cognizant of their customs compliance responsibilities or opted to concentrate on "more pressing" regulatory issues, such as those enforced by the IRS, SEC or other federal or state agency oversight bodies. Typically, our importer clients do not "get religion" about customs compliance until they are forced to by Customs, *eg*, faced with a customs audit or major penalty investigation.

With the advent of SOX, however, the customs compliance pendulum has swung, at least gradually, to the positive side. SOX compliance awareness has had a ripple effect among corporate importers who have begun, perhaps due to SEC reporting requirements rather than CBP compliance concerns, to take notice of customs compliance. More notably, significant importers, even those non-public or foreign-based companies not subject to SOX oversight, have begun conducting the types of internal customs compliance assessments envisioned by the Mod Act. Further, the number of companies

choosing to take advantage of the benefits afforded under Customs' ISA program has grown expeditiously since SOX reporting and recordkeeping requirements became effective. For example, in 2003, there were only 18 importers admitted to ISA. By contrast, as of this writing, there are 83 importers that have been admitted to ISA, with another 49 applications pending.

Customs struggled for almost a decade after the passage of the Customs Modernization and Informed Compliance Act to generate broad recognition by importers for customs compliance, notwithstanding its extensive outreach program during the mid-1990s. Although a major U.S. law enforcement and revenue generating agency, U.S. Customs had historically been the "Rodney Dangerfield" of the Department of Treasury, in that it "Didn't get no respect." While most major corporate importers took their other regulatory responsibilities seriously, Customs compliance was hardly at the forefront of their concerns.

With Congress enacting SOX as a result of a rash of accounting scandals within large corporations, many major corporate importers began for the first time, to consider customs compliance a part of their due diligence and reporting requirements under the Act. Therefore, Customs' compliance self-assessment initiative, and the SEC response to the wave of corporate scandals which led to the SOX's legal and ethical corporate compliance measures, have converged, accelerating Customs' two major goals: promoting reasonable care and internal compliance within the importing community and freeing-up Customs' limited resources to concentrate on Customs' new post-9/11 mandate to be an integral part of the nation's anti-terrorism efforts.



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