Financial Fraud Law Report

VOLUME 3 NUMBER 7 JULY/AUGUST 2011

The FINANCIAL FRAUD LAW REPORT is published 10 times per year by A.S. Pratt & Sons, 805 Fifteenth Street, NW., Third Floor, Washington, DC 20005-2207, For subscription information and customer service, call 1-800-572-2797. Direct any editorial inquires and send any material for publication to Steven A. Meyerowitz, Editor-in-Chief, Meyerowitz Communications Inc., PO Box 7080, Miller Place, NY 11764, smeyerow@optonline.net, 631.331.3908 (phone) / 631.331.3664 (fax). Material for publication is welcomed — articles, decisions, or other items of interest. POSTMASTER: Send address changes to the Financial Fraud Law Report, A.S. Pratt & Sons, 805 Fifteenth Street, NW., Third Floor, Washington, DC 20005-2207. *ISSN 1936-5586*

Government Launches FCPA Inquiry into Investments by Sovereign Wealth Funds in U.S. Banks and Private Equity Firms

BETTY SANTANGELO, GARY STEIN, SUNG-HEE SUH, AND PETER H. WHITE

In this article, the authors explain the Foreign Corrupt Practices Act, its anti-bribery provisions, and the legal risks arising from investments by sovereign wealth funds in U.S. banks and private investment funds. The article also describes actions firms should take to mitigate those risks and avoid potential legal liability and reputational harm.

In recent years, the U.S. Department of Justice ("DOJ") and the Securities and Exchange Commission ("SEC") have stepped up their enforcement of the anti-bribery provisions of the U.S. Foreign Corrupt Practices Act of 1977 ("FCPA"), imposing record criminal fines and civil penalties, such as the $800 million fine in 2008 against Siemens, the German conglomerate. The DOJ and SEC have declared FCPA enforcement a high priority, bulked up their enforcement teams, and shown a readiness to apply the statute in increasingly expansive and creative ways. Earlier this year, in a development that should be of particular interest to the private investment fund community, the *Wall Street Journal* reported that the SEC is investigating whether banks and private equity firms may have violated the FCPA in their dealings with sovereign wealth funds ("SWFs").[1]

The authors are partners at Schulte Roth & Zabel LLP. They may be contacted at betty.santangelo@srz.com, gary.stein@srz.com, sung-hee.suh@srz.com, and pete.white@srz.com, respectively. The authors wish to thank William I. Friedman, an associate at the firm, for his contributions to this article.

Published by A.S. Pratt in the July/August 2011 issue of the *Financial Fraud Law Report.*

SWFs have become an increasingly common source of investment capital for private investment funds in recent years, and have also acquired large stakes in major U.S. financial institutions.[2] Private investment funds that raise money from SWFs, or interact in other ways with foreign government agencies or government-owned entities, should be mindful of the legal risks arising from the FCPA and take steps to mitigate those risks and avoid potential legal liability and reputational harm.

THE FCPA AND ITS ANTI-BRIBERY PROVISIONS

The FCPA's anti-bribery provisions broadly apply to any U.S. citizen, U.S. company or U.S. issuer, and even to non-U.S. persons under certain circumstances.[3] The FCPA prohibits bribes offered or paid to any foreign official, foreign political party, official or candidate, or official of a public international organization, in order to assist in obtaining, retaining or directing business.[4] The official who receives the bribe need not be a governmental official in the classic sense, such as the head of a government ministry or agency; the statute broadly defines the term "foreign official" to encompass any officer or employee of any foreign government agency or instrumentality, including government-owned or operated business enterprises.[5]

The FCPA also includes a prohibition on indirect bribery covering any payment made to a third party with knowledge that all or a portion of the payment will be transmitted to a foreign official or any other prohibited party in order to assist in obtaining, retaining or directing business.[6] Under the statute's definition of "knowing" conduct, the entity or individual may be held liable based on awareness of a "high probability" that a payment was being made to a foreign official, even if the entity or individual did not have actual knowledge of that fact.[7] This provision allows the government to prosecute, on a "willful blindness" or "conscious avoidance" theory: use of third party intermediaries such as an agent retained to help the U.S. company obtain business in that country or a foreign joint venture partner.[8] In practice, many unlawful payments prosecuted under the FCPA are made through such third party intermediaries.

The government must also show corrupt intent under the anti-bribery provisions of the FCPA, in that the payment was intended to induce the recipient to misuse his or her official position or to secure an improper advantage.[9] A person who makes such a payment may be held liable under the FCPA, even if the person did not know the payment violated the statute and even if the payment was solicited by the foreign official.[10] Nor is it a defense that corruption is "how business is done" in the foreign country or that it would have been impossible to obtain a contract with the foreign government unless the payment was made. Moreover, the statute prohibits not only an actual improper payment, but also an offer, promise or authorization of such a payment.[11]

The anti-bribery provisions explicitly carve out payments for the purpose of expediting or securing the performance of a "routine governmental action," such as processing visas or providing phone service or water supply.[12] The FCPA also provides two affirmative defenses to alleged violations of the anti-bribery provisions, which are available for: (1) payments that are lawful under the written laws and regulations of the foreign official's country; or (2) reasonable and bona fide expenditures, such as travel and lodging expenses, incurred by or on behalf of the foreign official, foreign party, party official or candidate and directly related to the promotion, demonstration or explanation of products or services, or to the execution or performance of a contract with a foreign government or agency.[13] These exceptions and defenses are narrowly construed by the DOJ and SEC and their use should therefore be carefully controlled.

PRIVATE INVESTMENT FUNDS ARE EXPOSED TO FCPA RISK

Private investment funds that seek investments from foreign government-owned entities, such as SWFs or state-owned pension plans, are exposed to the risk of violating the FCPA's anti-bribery laws. Because SWFs are owned and operated by foreign governments, all of their directors, officers and employees qualify as foreign officials under the FCPA. Therefore, a private investment fund that makes payments, or offers gifts or entertainment, to insiders at an SWF for the purpose of inducing the SWF to invest in the fund, could face criminal prosecution or civil enforcement liability under the FCPA, as could individual employees of the fund.

Likewise, a private investment fund's use of placement agents or third party marketers to solicit investments on the fund's behalf from SWFs or other foreign government entities also raises an FCPA risk for the fund and its employees. If the third party intermediary makes an unlawful payment to an insider at the SWF in soliciting an investment for the private investment fund, the fund can face liability if there is evidence that the fund knew about the payments or was aware of "red flags" indicating that such a payment would be made but failed to take steps to stop the activity or investigate further.

There are FCPA risks for private investment funds not only in raising capital, but also in making investments. For example, a private investment fund that acquires a controlling interest in a portfolio company that engages in business overseas with foreign governments, or that enters into a joint venture with a foreign government entity, has exposure to FCPA risk. For a private investment fund acquiring an interest in an overseas business, or in a U.S. company that does business abroad, FCPA violations associated with the target company can be "a little like asbestos," in that the acquiring private investment fund will inherit financial responsibility for any FCPA violations committed prior to the acquisition by the target company.[14] In addition, if the acquired business continues to engage in FCPA violations following the change in ownership, the acquirer not only could face financial repercussions but could also find its own knowledge and conduct questioned in a government investigation. Accordingly, it is essential to conduct appropriate FCPA due diligence on target companies that engage in business with foreign governments.

WAYS TO REDUCE FCPA RISK

The contours of a private investment fund's FCPA compliance program should be commensurate with the fund's potential exposure under the FCPA, which will depend on the nature and extent of its interactions with foreign government entities, the jurisdictions in which the fund operates, the fund's use of placement agents and other third party intermediaries, and other factors. As a general matter, private investment funds should consider undertaking certain measures to reduce the fund's exposure to FCPA risk, such as:

- The promotion of an organizational culture among the private investment fund's employees, agents and business partners that encourages ethical conduct and a commitment to compliance with the law;
- The adoption of a written FCPA compliance policy and procedures that prohibit bribery and require relevant employees to certify, on an annual or other periodic basis, their compliance with the fund's FCPA policy and procedures;
- The delegation of operational responsibility for the private investment fund's FCPA compliance policy and procedures to one or more designated personnel, who should report periodically to management on the effectiveness of the program;
- FCPA training on a periodic basis for management and all personnel who have been identified by the fund as likely to face FCPA-related issues in order to ensure that such persons are aware of the FCPA and its restrictions and the fund's FCPA compliance policy and procedures; and
- The maintenance of accurate books and records of all transactions that, directly or indirectly, involve gifts or payments to foreign officials.

Private investment funds that use placement agents, third party marketers or other intermediaries in dealing with SWFs and other foreign government entities should consider taking certain additional steps, as set forth below, to mitigate the fund's FCPA risk:

- Provisions in the firm's FCPA policy and procedures that set forth a process for vetting third party intermediaries, and that require the approval of designated senior business executives and/or in-house legal or compliance personnel, before the intermediary is retained by the fund;
- Pre-retention due diligence of third party intermediaries to ensure that the intermediary is legitimate and reputable and that there are no red flags indicating that the intermediary would be prepared to pay bribes to foreign officials;

- Appropriate contractual representations with third party intermediaries relating to compliance with the FCPA and relevant foreign anti-corruption laws; confirming that no foreign official is an owner of or otherwise has a financial interest in the intermediary; and providing for termination as a result of any breach of applicable anti-corruption laws; and
- Periodic certifications from the third party intermediary attesting to the intermediary's compliance with the FCPA and all other relevant foreign anti-corruption laws.

A firm's FCPA policy and procedures should also address the subject of gifts and business entertainment. There is no dollar threshold or other formula for distinguishing permissible from impermissible gifts and entertainment under the FCPA. Providing a small, non-cash gift of nominal value, or paying for a business-related lunch or dinner, should be permissible so long as it is not designed to influence the foreign official's action or to obtain an improper advantage. To mitigate risk in this area, a firm's policy should set forth objective guidelines and pre-approval requirements. The gift or expenditure should also be permissible under both the foreign country's law and the guidelines of the employer of the foreign governmental official or employee.

While every private investment fund's FCPA compliance needs will differ, these basic measures should help substantially to reduce the likelihood that the private investment fund or its employees will become the target of an investigation or action by the DOJ or the SEC.

NOTES

[1] *See* Dionne Searcey & Randall Smith, "SEC Probes Banks, Buyout Shops Over Dealings With Sovereign Funds," *Wall Street Journal*, Jan. 14, 2011.

[2] *See* "Sovereign Wealth Funds Investing in Hedge Funds," June 1, 2010, www.hedgefundmarketing.org; Mina Kimes, "Sovereign Wealth Funds on the Hunt," *Fortune*, Dec. 23, 2009.

[3] The FCPA's anti-bribery provisions include three separate prongs, applicable to (1) U.S. issuers, *see* 15 U.S.C. § 78dd-1, (2) "domestic concerns" (U.S.

citizens and companies), *see* 15 U.S.C. § 78dd-2, and (3) any person other than U.S. issuers and domestic concerns, see 15 U.S.C. § 78dd-3. Under the last prong, the FCPA applies to non-U.S. individuals and entities who commit an act in furtherance of an unlawful bribe while in the territory of the United States. *See* 15 U.S.C. § 78dd-3(a). The DOJ broadly interprets the statute to reach foreign persons who, while never entering the United States, cause an act in furtherance of the bribe to take place within the United States.

[4] 15 U.S.C. § 78dd-1(a); 15 U.S.C. § 78dd-2(a); 15 U.S.C. § 78dd-3(a).

[5] 15 U.S.C. § 78dd-1(f)(1)(A); 15 U.S.C. § 78dd-2(h)(1)(2)(A); 15 U.S.C. § 78dd-3(f)(2)(A). *See United States v. Aguilar*, __ F. Supp. 2d ___ , 2011 WL 1792564 (C.D. Cal. Apr. 20, 2011) (rejecting defense argument that Congress did not intend employees of state-owned companies to be covered by the FCPA).

[6] 15 U.S.C. § 78dd-1(a)(3); 15 U.S.C. § 78dd-2(a)(3); 15 U.S.C. § 78dd-3(a)(3).

[7] 15 U.S.C. § 78dd-1(f)(2); 15 U.S.C. § 78dd-2(h)(3); 15 U.S.C. § 78dd-3(f)(3).

[8] *See United States v. Kozeny*, 664 F. Supp. 2d 369, 385 n.130 (S.D.N.Y. 2009).

[9] 15 U.S.C. § 78dd-1(a); 15 U.S.C. § 78dd-2(a); 15 U.S.C. § 78dd-3(a).

[10] *See United States v. Kay*, 513 F.3d 432, 447-48 (5th Cir. 2007); *Stichting Ter Behartiging v. Schreiber*, 327 F.3d 173, 183 (2d Cir. 2003); S. Rep. No. 114, 95th Cong., 1st Sess., at 11 (1977).

[11] 15 U.S.C. § 78dd-1(a); 15 U.S.C. § 78dd-2(a); 15 U.S.C. § 78dd-3(a).

[12] 15 U.S.C. § 78dd-1(b),(f)(3); 15 U.S.C. § 78dd-2(b),(h)(4); 15 U.S.C. § 78dd-3(b)(f)(4).

[13] 15 U.S.C. § 78dd-1(c); 15 U.S.C. § 78dd-2(c); 15 U.S.C. § 78dd-3(c).

[14] *See* Mark Brzezinski, "That Bribe Could Be Costly," *New York Times*, Nov. 10, 2010.

Schulte Roth & Zabel

Schulte Roth & Zabel LLP
New York
919 Third Avenue
New York, NY 10022
+1 212.756.2000
+1 212.593.5955 fax

www.srz.com

Schulte Roth & Zabel LLP
Washington, DC
1152 Fifteenth Street, NW, Suite 850
Washington, DC 20005
+1 202.729.7470
+1 202.730.4520 fax

Schulte Roth & Zabel International LLP
London
Heathcoat House, 20 Savile Row
London W1S 3PR
+44 (0) 20 7081 8000
+44 (0) 20 7081 8010 fax