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In the Crossfire
Why Private Equity Firms, Investment Funds & Their Managers Should Beware of the Foreign Corrupt Practices Act

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Lance Armstrong and the world of competitive cycling has come under great scrutiny in recent days with the domination of the U.S. Postal team now undermined by the systematic doping that appears to have helped spur the team to victory year after year. Cheating, or getting an unfair edge over the competition, is antithetical to the American public's view of sports, where an equal playing field is considered the ethical baseline. The Foreign Corrupt Practices Act (FCPA),[1] which prohibits commercial bribery of foreign government officials, is the U.S. Anti-Doping Association's equivalent for U.S. firms engaged in overseas investment activity. Designed to eliminate corruption in the global marketplace, the FCPA has become a priority enforcement tool for the U.S. government to ensure a level commercial field by punishing the rule-breakers.

It is long past time for private equity firms and investment funds to learn the rules. In physics, it is said that to every action there is always an equal and opposite reaction.[2] This maxim applies with equal force to the

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private investment industry's increasing expansion into emerging markets in underdeveloped economies. While this extraterritorial activity has exposed hedge funds and private equity firms to a host of lucrative investment opportunities, it has also exposed the firms and their senior managers to potential criminal liability under the FCPA.

In some respects, the timing could not be worse. Over the last decade, FCPA enforcement has come of age as one of the most effective anticorruption tools available to the U.S. government. The Department of Justice (DOJ) and Securities and Exchange Commission (SEC) have opened hundreds of investigations, recovered billions of dollars in penalties, and secured the criminal convictions of dozens of individuals under the FCPA. This enforcement frenzy is here to stay. Last year, then-Secretary of State Hillary Clinton endorsed the DOJ and SEC's aggressive approach against international corruption, reaffirming that the current Administration is "unequivocally opposed to weakening the Foreign Corrupt Practices Act."[3] Just last month, President Barack Obama appointed a former criminal prosecutor, Mary Jo White, to head the SEC for the first time in its history.[4] The message is clear: the criminalization of corrupt anticompetitive activity abroad has become a top enforcement priority for the federal government.

Bottom line, in this era of increased regulation and Occupy Wall Street, the private investment industry cannot continue to fly under the FCPA radar. Recent activity by the DOJ and SEC, including the release of a lengthy Resource Guide to the U.S. Foreign Corrupt Practices Act (FCPA Resource Guide) that expressly references broker-dealers and investment advisers,[5] suggests that the financial industry is fair game under the FCPA. Despite all this regulatory noise, hedge funds and private equity firms should not be deterred from pursuing extraterritorial growth. Rather, the private investment industry should enter these higher risk markets with its eyes open and leverage the FCPA guidance as an opportunity to add rigor to its due diligence processes, compliance programs and internal controls.

Enforcing a Competitive Marketplace

The FCPA empowers the DOJ and SEC to prosecute and sanction corporate entities and their agents for bribing foreign government officials.[6] At the center of the U.S. government's deterrence of corruption in the increasingly globalized economy, the FCPA's aggressive application in recent years has resulted in high-profile enforcement actions against some of the largest multinational companies and their executives.

Congress enacted the FCPA in times not unlike the present. Symbolized by the infamous Watergate scandal, the 1970s highlighted in the minds of the American public the disintegration of ethics in government. With little confidence in the playing field at home, there was concern that competition for market share in foreign government-controlled industries—and particularly those existing in less developed countries—had fostered a "race to the bottom" of ethical business practice.[7] A 1976 survey by the SEC confirmed these suspicions when more than 400 U.S. companies acknowledged that they had paid more than $300 million in bribes to foreign officials in order to gain or maintain a competitive advantage.[8]

These business practices were not illegal at that time. Throughout its history, Congress had disfavored extraterritorial legislation in this area, seeking instead to promote the uninhibited expansion of U.S. business interests overseas. With the issuance of the 1976 SEC report, there was mounting public demand for legislative action. Congress worried that bribery eroded public confidence in the integrity of the free market system, rewarded corruption instead of efficiency in the foreign marketplace, and threatened United States foreign policy.[9] In 1977, within months of the SEC report, Congress enacted the FCPA to prohibit corporate bribery abroad and encourage proper bookkeeping at home.[10]

After some reluctance due in part to the perception that the FCPA unfairly disadvantaged U.S. companies when their foreign counterparts were not subject to similar prohibitions,[11] the DOJ and SEC have pursued FCPA enforcement actions in

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recent years with renewed vengeance. The SEC recently created a specialized national FCPA unit as part of its Enforcement Division.[12] There are currently more than 100 active enforcement investigations for suspected violations under the FCPA,[13] and these numbers are expected to rise. In 2012, the DOJ and SEC initiated nearly 30 new FCPA investigations, the most in five years. Since 2005, the DOJ has brought more FCPA enforcement actions than in the previous 28 years, resulting in the recovery of record-setting penalties. In 2010 alone, FCPA penalties exceeded $1 billion, more than doubling the $453 million collected in 2009.[14]

Perhaps the most significant development in FCPA enforcement in the last few years, however, has been the government's appetite for prosecuting individuals. These are criminal enforcement actions with the sanction of imprisonment, and provide even more reason for fund managers to pay heed to the restrictions in the statute and ensure that sufficient diligence protocols are in place to avoid running afoul of U.S. law.

The FCPA in a Nutshell

The FCPA's anticorruption objectives are attained through two main components: the books and records provisions and the antibribery provisions.[15] The books and records provisions require SEC issuers to maintain accurate record-keeping and transparent accounting and controls to deter corrupt business practices. The section prohibiting the payment of bribes to foreign officials applies more broadly to U.S. companies and individuals (or residents thereof) engaged in business involving foreign governments, which includes hedge funds, private equity firms, and entities and individuals under their control, as that evolving legal concept is interpreted by the federal enforcement authorities.

The Books & Records Provisions

The books and records provisions require "issuers" to maintain books and records that fairly and accurately reflect the company's transactions, and to devise and maintain a system of internal accounting controls.[16] "Issuers" are companies that list securities and are required to make periodic reports under the Securities and Exchange Act.[17] This includes most publicly traded companies as well as companies that issue American Depository Shares (ADRs) that are registered and traded on a U.S. exchange.

There is ample administrative guidance how to comply with the books and records provisions, including SEC Rules 13b2-1 and 13b2-2.[18] The SEC has also provided guidance about the factors it considers when determining the adequacy of a company's internal accounting controls.[19] While not an "issuer" under the SEC regulations, a private investment firm is well advised to adopt these best practices in its accounting controls.[20] A company with misleading books and records is far more likely to be prosecuted under a variety of federal statutes, including the FCPA's anti-bribery provisions.

The Anti-Bribery Provisions

The antibribery provisions broadly proscribe all "domestic concerns" from offering or paying anything of value to a foreign official, or other person for transfer to a foreign official, for the purpose of retaining or obtaining business. "Domestic concerns" include: (*i*) any individual who is a citizen, national, or resident of the United States; (*ii*) any corporation, partnership, association, joint-stock company, business trust, unincorporated organization, or sole proprietorship which has its principal place of business in the United States, or which is organized under the laws of the United States; and (*iii*) any officer, director, employee or agent acting on behalf of a domestic concern.[21] The statute's reach is extensive; even if the wrongdoer is a foreign company or individual, the DOJ and SEC may assert jurisdiction if at least part of the conduct in furtherance of the bribe was domestic.

Private investment funds that operate through foreign arms or agents may also be captured by this wide net. It is not a defense to an FCPA violation that the improper conduct was committed by a foreign affiliate of the U.S. private investment firm, or a consultant or agent of the foreign affiliate. The DOJ and SEC may assert criminal and

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civil jurisdiction against U.S. companies and residents if they are deemed to have control over the foreign entity or agent that procured the illegal bribe. Control is not clearly defined in the statute nor the FCPA Resource Guide and may be found in any circumstance where the U.S. company or individual exercises management control over the foreign wrongdoer, whether through joint venture, a seat on the board of the foreign entity, voting power or other ability to influence the affairs of the foreign affiliate.[22]

The extended reach of the FCPA is illustrated by the U.S. government's enforcement action against the large German insurer Allianz SE.[23] Allianz owned a passive, majority stake in a portfolio company, PT Asuransi Allianz Utama, and had no management control of Utama's day-to-day operations. Nevertheless, beginning in 2005, Allianz received a series of anonymous tips that Utama employees had made improper payments to Indonesian government officials in connection with its business dealings in that country. Allianz conducted an internal investigation and disclosed the improper conduct to U.S. enforcement authorities. Despite the passive nature of Allianz's stake in the portfolio company that made the improper payments and the company's voluntary disclosure, the SEC brought an enforcement action that resulted in a $7 million civil penalty against the company for violations of the FCPA's books and records provisions.

The rest of the statutory terms are similarly applied with a broad brush. The recipient of such a bribe—the foreign official under the FCPA—is widely defined as any officer or employee of a foreign government, public international organization, or any department or agency thereof, or any person acting in an official capacity, as well any candidate for foreign office.[24] A prohibited payment may be "anything of value," which applies not just to financial transactions but could include a wide range of benefits beyond money, including gifts, sponsorships and entertainment.[25] The materiality of what is promised, given, paid or offered may not be relevant for FCPA liability to attach, so relatively small gifts or services can land a firm and its managers in trouble.[26] Company sponsored conferences held in vacation locales, for example, may raise FCPA concerns if foreign government officials attend.

The FCPA provides two limited affirmative defenses to an antibribery violation for (*i*) payments that are lawful under the written laws and regulations of the foreign country[27] and (*ii*) "facilitating payments" or reasonable and bona fide expenditures used to expedite or "grease" routine governmental action.[28] The FCPA Resource Guide suggests that these defenses are narrowly construed, and accordingly there remains considerable uncertainty about the wide scope of activity captured by the antibribery provisions.

In the Crossfire

The FCPA enforcement eye tends to focus its lens on particular industries. That the private investment industry is currently in the government's sights is no secret. Indeed, the government's recently released FCPA Resource Guide singles out the private investment business as an industry rife with FCPA-related concerns.[29]

The public outcry over some of the fraudulent activities exposed within the financial industry has instigated a rise in regulation. Following the recent wave of highly publicized investment scandals involving U.S. managers and overseas investment schemes like those perpetrated by Bernard Madoff and Allen Stanford, the government's heightened enforcement interest in hedge funds and private equity firms comes as no surprise.[30] DOJ has brought a wave of insider trading cases to crack down on misconduct in the investment industry. Some hedge funds are now required to register with the SEC, which has promulgated regulations designed to increase transparency in the industry and root out corruption. The Dodd-Frank Wall Street Reform and Consumer Protection Act[31] and other statutes provide financial incentives for whistleblowers to report securities violations, including violations of the FCPA.

Skating on Thin FCPA Ice

And the risks continue to grow as U.S. firms embark on unchartered terrain. There has been an unprecedented amount of U.S. investment

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activity in foreign jurisdictions plagued with corruption, including government-owned assets such as nationalized commodities and sovereign wealth funds. The latest Corruption Perception Index (CPI), which ranks countries based upon perceived levels of public sector corruption,[32] demonstrates why operating in certain geographic regions heightens the risk of FCPA liability.[33] Private equity firms and hedge funds with investment activity in China, Russia, Africa, Latin America, Southeast Asia and the Middle East are exposed to greater risks of engaging in practices deemed to violate the FCPA's antibribery provisions. Of 176 listed countries, China ranked 80th and Russia ranked 123rd.[34] Many countries in South America, Southeast Asia, the Middle East and Africa (which are also rated at the bottom half of the index) continue to show marked increases in corruption.[35] The continued expansion of the private investment industry into foreign jurisdictions with high levels of public corruption guarantees that hedge funds and private equity firms will remain a target of FCPA enforcement for the foreseeable future.

The FCPA risks for the private investment industry stem from both inbound activity, *i.e.* when a U.S. portfolio firm is looking to secure funds from a foreign sovereign wealth fund; and outbound activity, *i.e.* when a U.S. hedge fund or private equity firm seeks to invest in a government-owned company in a foreign jurisdiction. These investments often require a third-party placement agent or fixer to broker the investment relationships with foreign officials. If this third-party agent makes improper payments to foreign officials to obtain or maintain the investment relationship, the private investment company and its managers are criminally liable under the FCPA if they know the improper payments were made, or consciously disregard or willfully blind themselves to the improper activity. Investment companies that rely on third parties to arrange the outbound or inbound foreign investments cannot plead ignorance under the FCPA.

Inbound Foreign Investments: *The Rise of Sovereign Wealth Funds*

Despite these signposts of corruption, inbound investment activity involving government-owned entities in these high-risk jurisdictions is on the rise. This is due, in large part, to the potentially lucrative investment opportunities with sovereign wealth funds. These investment funds, which are owned and operated by foreign governments, are common in developing and developed countries looking to preserve and increase the revenues generated by their state-owned natural resource industries. Asia and North Africa, jurisdictions with some of the highest CPI ratings of public sector corruption, are home to 57% of all sovereign wealth funds and 75% of the aggregate assets held by these funds.[36] Investing billions of dollars in highly diversified portfolios,[37] sovereign wealth funds are lucrative investors for U.S. money managers. It is estimated that more than one-third of sovereign wealth funds invest in hedge funds, and more than half invest in private equity ventures.[38] Indeed, during the height of the most recent financial crisis, U.S. money managers relied heavily on sovereign wealth funds to provide critical capital to their troubled private investment firms.[39]

Because these funds are controlled by foreign governmental entities, their directors, officers and employees qualify as "foreign officials" under the FCPA. This has not missed the attention of the U.S. government, and on January 4, 2011, the SEC announced that it was launching a widespread investigation as to whether private equity firms, banks and other investment companies violated the FCPA's antibribery provisions in their dealings with sovereign wealth funds.[40] These investigations are comprehensive and take time, as they examine the use of third-party agents, gift and entertainment practices, and the books and records to determine whether these private investment companies sufficiently monitored their investment relationships with the sovereign wealth funds and their representatives to avoid the provision of payments or other benefits that may be culturally acceptable in certain foreign jurisdictions but run afoul of the U.S. statute.

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Outbound Foreign Investments: *Buyers Beware*

The private investment industry continues to explore new investment opportunities in emerging economies throughout the world where natural resources are rich and infrastructure is developing. In many countries, these industries, along with the local banks providing the funding, are government owned and operated. These types of overseas investments often involve third-party agents to make introductions and broker the investment relationship between the private investment firm and the foreign governmental entity. Apart from administrative "grease payments" to facilitate routine government actions, other payments made to foreign officials will subject a U.S. firm and its managers to liability under the FCPA.

To avoid FCPA liability, investors are expected to conduct preacquisition FCPA diligence and terminate any problematic third-party relationships to ensure that no continuing violations take place. For example, in 2007, the DOJ brought an enforcement action against eLandia International as a result of bribes paid by Latin Node, Inc. to foreign government officials prior to eLandia's acquisition of the company. Despite the fact that eLandia uncovered Latin Node's misconduct after the acquisition, DOJ imposed a $2 million civil penalty on eLandia for its failure to discover Latin Node's improper payments in its preacquisition due diligence.[41]

Companies are also expected to conduct postacquisition FCPA monitoring to an even deeper degree, as criminal prosecution of a company and its managers is far more likely if the corrupt activity continues under the oversight of the successor company. The DOJ and SEC expect private investment firms to conduct FCPA diligence down the corporate investment chain. Downstream diligence is necessary because FCPA liability may attach even if the outbound foreign investment is held by a domestic portfolio company. Failure of a private investment company to monitor its portfolio company's investment with foreign officials, including any agents used to secure the investment, may expose the private equity firm and its U.S. portfolio company to direct or indirect FCPA liability.

The DOJ has pursued investigations of private equity consortiums that own portfolio companies whose subsidiaries have engaged in corrupt activity. For example, a private equity consortium that acquired Vetco International Ltd. (Vetco) failed to conduct adequate postacquisition due diligence of Vetco's underlying subsidiaries. The DOJ opened an FCPA investigation against Vetco and its private equity consortium owner after it uncovered a series of bribes made by Vetco's subsidiaries to foreign government officials. The consortium managed to avoid a criminal charge based on its cooperation with the federal investigation, but the DOJ's imposition of a $26 million penalty on Vetco's subsidiaries weakened the portfolio company's financial position and vastly reduced the value of the consortium's investment.[42]

FCPA liability is not limited to the postinvestment conduct of a private equity firm or its portfolio company. Under the FCPA, a private equity firm or investment fund that acquires a controlling interest in a company assumes all the liabilities of the predecessor company, including any existing violations of the FCPA.[43]

Where the Wild Things Are

There is perhaps no better illustration of the challenges and pitfalls facing private investment companies that invest in foreign assets than the FCPA enforcement actions stemming from the Oily Rock Ltd. investments in the Azerbaijan oil industry.[44] Oily Rock was an investment company controlled by Viktor Kozeny, a Czech national with a well-earned reputation as the "Pirate of Prague." Oily Rock was established to invest in Azerbaijan's lucrative oil industry, and Kozeny solicited funds from various American investors, including a New York hedge fund, a Colorado investor and AIG's investment fund.[45]

The Oily Rock investment proved to be a tremendous failure, and each of the U.S. investors found themselves embroiled in a federal investigation even though none of them were directly involved in the payment of the bribes. Kozeny had paid exorbitant bribes to Azeri government

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officials to arrange Oily Rock's access to the Azeri oil industry. The DOJ brought criminal charges against an officer of the New York hedge fund investor based on allegations that he had knowledge of Kozeny's bribes. These charges resulted in a plea agreement and a civil penalty.

The Colorado investor had created a separate company in an attempt to distance himself and his investors from any wrongdoing committed by Oily Rock and Kozeny in securing the Azeri investment. He was convicted of violating the FCPA's antibribery provisions based on a "willful blindness" theory despite his efforts to create an entity structure to shield himself from criminal liability for the bribes. Only the AIG investment fund manager escaped criminal conviction under the FCPA. His criminal charges were dropped largely due to the small and passive nature of AIG's investment; Oily Rock only represented less than 1% of AIG's investment portfolio.

How to Manage the Risks

The Oily Rock criminal prosecutions demonstrate just how far the U.S. enforcement authorities will reach to punish U.S.-based investment funds and managers that invest overseas with passive knowledge of corrupt foreign payments or inadequate FCPA diligence. With DOJ and SEC enforcement zeroed-in on the investment industry, hedge funds, portfolios companies and private equity firms must redouble their efforts to implement effective compliance programs and internal controls to avoid running afoul of the FCPA. While it is not clear how aggressively the government will pursue criminal sanctions against investment funds and their managers in particular cases, there is no mystery as to what the government expects investment firms to do in terms of compliance. And the best way to avoid a criminal prosecution is to have a rigorous compliance program.[46]

The FCPA Resource Guide sets forth the key components of an anticorruption compliance program, which include: (*i*) a commitment from senior management to establish a clearly articulated anticorruption policy and code of conduct; (*ii*) sufficiently senior leadership of an independent compliance function with responsibility for implementation of the program; (*iii*) monitoring of third-party agents and intermediaries; (*iv*) management and employee training; (*v*) confidential reporting and internal investigation; (*vi*) periodic testing and program review; and (*vii*) the imposition of disciplinary measures in the event of employee noncompliance.[47]

Private investment firms are expected to conduct sufficient pre-investment (pre-acquisition) and post-investment (post-acquisition) due diligence to uncover potential red flags of FCPA noncompliance. That diligence should include a review of the books and records to identify any unusual payment patterns or financial arrangements, unusually high commissions, or lack of transparency in expenses and accounting records. Third-party consultant arrangements and investment partners should be closely examined to investigate (*i*) whether the consultant or investment partner has been recommended by a foreign government official; (*ii*) any apparent lack of qualifications or resources on the part of the investment partner or representative to perform the services offered; or (*iii*) a refusal by the foreign investment partner or consultant to provide a written FCPA compliance certification.[48] All of these factors should be considered in light of the history of corruption in the country at issue, the nature of the investment activity, and its nexus to the foreign government.

The FCPA Resource Guide encourages companies to self-report any improper activity and cooperate with the government's investigation as the best way to mitigate any potential criminal penalties imposed on the company and its employees.

Conclusion

There is no question that the private investment industry is in the front-line sights of the U.S. enforcement authorities. When investing in the global marketplace, a proactive approach to implement the controls necessary to avoid running afoul of the FCPA makes good business sense. Pre-investment FCPA due diligence arms a hedge fund, private equity firm or investment company

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with a more accurate representation of the risks associated with a potential investment or acquisition. Post-investment, effective due diligence and monitoring of an investment or acquired company's operations is essential to the company's risk management of its investment portfolio. Risk assessment, after all, is the bailiwick of the private investment industry, and FCPA compliance must now be a priority item on the agenda.

END NOTES

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10. *See* H.R. Rep. No. 95-640, at 4-6; 15 U.S.C.A. § 78m(b) (2012).
11. Similar anticorruption statutes have since been passed in Europe and other parts of the world as a result of international cooperation on these efforts. *FCPA Resource Guide*, at pp. 7-8. In 2010, the U.K. Bribery Act established even broader anticorruption rules that encompass any form of commercial bribery whether or not a government official is involved and prohibits all types of facilitating payments. Joe Palazzolo, *Economist: UK Bribery Act is 'Smarter' Than FCPA*, Wall Street Journal, September 15, 2011, available at http://blogs.wsj.com/corruption-currents/2011/09/15/economist-uk-bribery-act-is-smarter-than-fcpa. Brazil is considering the enactment of similar legislation to combat crippling corruption in its financial industries and dozens of other countries are following suit. Stella Dawson, *Lawyers Warn Against Weakening Brazil Anti-Bribery Bill*, TrustLaw, November 2, 2012, available at http://www.trust.org/trustlaw/news/lawyers-warn-against-weakening-brazil-anti-bribery-bill.
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26. *See* FCPA, 15 U.S.C.A. § 78dd-1(a) (1998); *FCPA Resource Guide*, at p. 21.
27. FCPA, 15 U.S.C.A. §§ 78dd-1(c)(1), 78dd-2(c)(1), 78dd-3(c)(1) (1998).
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45. *See U.S. v. Kozeny*, at 535.
46. *FCPA Resource Guide*, at pp. 52-65; *see also* U.S. Sentencing Guidelines Manual §§ 8B - C (2011).
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