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FCPA Regulators Set Sights On Private Equity

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The private equity industry is the latest target of an unprecedented explosion in Foreign Corrupt Practices Act ("FCPA") enforcement by U.S. regulators. As the industry expands to emerging markets overseas and faces new Dodd-Frank regulations, private equity firms and hedge funds are under heightened scrutiny from the Department of Justice ("DOJ") and Securities and Exchange Commission ("SEC"). Recent developments highlight the importance – now, perhaps more than ever – of effective FCPA compliance programs for private equity firms and hedge funds, as well as their portfolio companies.

Recent Developments In FCPA Enforcement

The current surge in FCPA enforcement began around 2005. Since that time, the DOJ has instituted more FCPA prosecutions than in the previous 28 years of the statute's existence. In 2010 alone, penalties obtained from FCPA settlements exceeded $1 billion, more than doubling the prior record of $453 million in 2009. Also in 2010, the SEC announced the reorganization of its Enforcement Division, including the creation of a specialized national FCPA unit. Yet another important development in 2010 was the passage of the Dodd-Frank Wall Street Reform and Consumer Protection Act, which – among other significant provisions – offers monetary incentives to whistleblowers who report unlawful activity. These factors highlight the increasing risk of FCPA liability generally. In recent months, however, it has become clear that private equity firms and hedge funds are particularly at risk.

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Increasing Focus On Private Equity

One trend in U.S. FCPA enforcement has been the targeting of entire industries – such as the medical device, pharmaceutical and oil services industries – and the private equity industry is the government's latest target. At risk are not just publicly traded financial firms but privately held firms as well. While the SEC has more limited jurisdiction over FCPA enforcement, the DOJ can investigate and prosecute *any* U.S. entity whether publicly traded or privately held.[1] The following examples highlight current and recent initiatives by U.S. regulators to root out potential FCPA violations in the private equity industry.

Sovereign Wealth Fund FCPA Investigations

On January 14, 2011, the *Wall Street Journal* reported that the SEC launched an investigation to determine whether certain U.S.-based banks, hedge funds and private equity firms violated the FCPA by making unlawful payments in connection with obtaining or seeking to obtain investments from sovereign wealth funds.[2] Sovereign wealth funds are large sums of government money that are used for investment purposes. Recent data shows that more than a third of sovereign wealth funds invest some portion of their cash in hedge funds, and more than one half invest in private equity.[3] The SEC's investigation appears to focus on whether the financial firms provided illegal payments or excessive travel or entertainment expenses to employees or representatives of sovereign wealth funds in exchange for favorable treatment. Goldman Sachs is one of the banks under investigation. At issue in that case is whether Goldman violated the FCPA by initially agreeing to pay a $50 million fee that would have been passed along to a politically connected investment manager. Although the fee was never paid, the mere offer to pay would be sufficient to implicate the broad-reaching FCPA.

It is unclear whether the DOJ is currently involved in these sovereign wealth fund investigations, but any information uncovered in the investigations could be used by the DOJ to bring charges against any public or private company, or any individual (or any foreign company or national with the requisite ties to the U.S.). In light of the current climate, it is crucial for private equity firms and hedge funds to use caution when soliciting investors with ties to foreign governments. Unwarranted fees and excessive entertainment or travel expenses are red flags for potential FCPA problems. The use of placement agents in foreign countries is similarly under heightened scrutiny, as U.S. firms can be held liable

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for bribery committed by agents or other third parties anywhere in the world.

FCPA Liability for Portfolio Companies and Other Investments

Private equity firms and hedge funds also face potential FCPA liability for bribery committed at their portfolio companies, regardless of whether those portfolio companies are publicly traded or privately held and even if the bribery occurred before the acquisition. Assume, for example, that a U.S firm acquires a company that has violated the FCPA in the past. That firm inherits the liability of the portfolio company for its past actions. Moreover, the firm could potentially be held liable for any FCPA violations that occur after the acquisition, even if there is no evidence that the firm or its officers directly knew of the bribes. Thus, before acquiring a company, private equity firms and hedge funds must conduct due diligence to uncover and deal with any potential FCPA violations. Likewise, after the acquisition, firms must ensure that the company maintains an effective compliance program to detect and prevent FCPA violations.

A recent government investigation highlights the reality of the risks associated with portfolio companies. Allianz SE, Europe's largest insurer, has been under investigation in the U.S. for alleged corruption at a joint venture in Indonesia, as well as at a German printing equipment maker it owns through a private equity arm. The Indonesia matter is expected to result in a settlement. The SEC reportedly decided last month not to bring charges related to the private equity holdings, but that decision apparently was due to unique factors (such as German ownership laws that make it difficult to obtain information) and should not be viewed as an indication that the government will soften its FCPA enforcement efforts in this area.

The FCPA risks also extend to other investments beyond portfolio companies. In 2007, for example, hedge fund Omega Advisors agreed to pay a $500,000 civil penalty as part of a non-prosecution agreement with the DOJ relating to Omega's investment in a privatization program in Azerbaijan alongside Czech national Viktor Kozeny. As part of the non-prosecution agreement, Omega acknowledged that one of its former employees had learned, prior to Omega's investment, that Kozeny had entered into arrangements with some officials of the government of Azerbaijan that gave those officials a financial interest in the privatization of certain Azeri industries.

New SEC Dodd-Frank Rules

Yet another development affecting the private equity industry is the SEC's promulgation in 2011 of new rules pursuant to the Dodd-Frank Act, which impose greater registration and disclosure requirements upon hedge fund and private equity fund advisers. While these new rules were not primarily intended to assist with FCPA enforcement, as a practical matter this greater transparency will make it easier for U.S. regulators to learn details about hedge funds and private equity funds, as well as their advisers, that could eventually assist the government in an FCPA investigation or enforcement action.

FCPA Private Equity Checklist

As these recent developments illustrate, the private equity industry now faces very real and significant FCPA risks that only a few years ago were not a grave concern. In light of the current climate, hedge funds and private equity firms are advised to ensure that effective FCPA programs are in place not only in-house, but also at all portfolio companies. There is no one-size-fits-all compliance program. To be effective, a compliance program must be individually tailored to the particular risk factors affecting the entity at issue. Nevertheless, the following is a general summary of important issues to consider when developing an FCPA compliance program:

Written Policies and Internal Controls. A crucial aspect of any FCPA compliance program is the creation of written policies and internal controls designed to prevent FCPA violations. Though not a guarantee of FCPA compliance, the existence or absence of effective written policies and internal controls is a highly significant factor in the government's determination of the appropriate fines and penalties in the event of a violation.

Training. Even the best internal controls will not be effective unless they are communicated to those whose conduct could trigger FCPA liability. Thus, funds and firms should ensure that comprehensive training on the applicable policies and procedures is provided to all employees, as well as portfolio companies' employees and third parties such as agents (including placement agents), distributors and business partners.

Due Diligence. In order to limit exposure to liability for portfolio companies' FCPA violations, private equity firms and hedge funds should conduct thorough due diligence prior to any acquisition to uncover any potential FCPA issues with the target entity. Notably, the discovery of potential FCPA problems can be used as a negotiating tool to the advantage of the acquiring firm, but only if the problems are resolved prior to the acquisition.

Third-Party Policies. Prior to the engagement of third-party services, adequate due diligence must be conducted to identify and address any FCPA red flags associated with that third party. Common third-party red flags include connections with foreign officials; history or reputation of corruption in the geographic area in which the third party does business; refusal to confirm compliance with the FCPA; history of investigations or prosecutions for improper conduct; inconsistent invoicing; and requests for large commissions, retainers, fees, premiums or cash.

Audits. Private equity firms and hedge funds should conduct periodic audits to determine whether applicable FCPA compliance policies are being followed.

Enforcement. Immediate and decisive action must be taken against any employee or third party who violates the FCPA or applicable FCPA compliance policies.

DOJ Opinion Procedure. The DOJ's Opinion Procedure is an underutilized yet important tool to determine whether a particular course of action would, in the DOJ's view, implicate or violate the FCPA's anti-bribery provisions.

Addressing Potential FCPA Violations. In the event of the discovery of a potential FCPA violation, immediate consultation with an experienced and qualified attorney is essential to determining the best course of action. In appropriate cases, early and voluntary cooperation with the government can forestall an official investigation or prosecution, or at least minimize the degree of sanctions imposed.

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[1] *The DOJ also has FCPA enforcement jurisdiction over all U.S. individuals, as well as foreign companies and nationals with the requisite nexus to the U.S.*

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

[3] *See* "Sovereign Wealth Funds Investing in Hedge Funds," June 1, 2010, available at http://www. hedgefundmarketing.org/sovereign-wealth-funds-investing-in-hedge-funds (last visited November 2, 2011).