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PRIVATE EQUITY

Private Equity FCPA Enforcement: High Risk or Hype?

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Extraction, engineering, pharmaceuticals and medical device manufacturers. What do all of these industries have in common? FCPA prosecutors have "been there and done that," sweeping through these industries. Whose doorstep will U.S. enforcement arrive at next? The answer may very well be private equity firms. The key to entry: Dodd-Frank and the SEC's new presence exams.

The financial services industry ranks number seven in FCPA enforcement,[1] the SEC publicly asserts that it is looking at private equity,[2] and FCPA has been proclaimed an enforcement priority, with the budgets to match.[3] Thus, the storm clouds are gathering over the private equity homestead. Then again, it has been more than two years since regulators began poring over documents as part of presence exams and the question still remains: Will FCPA enforcement in private equity result in a spring shower or a hurricane? But if private equity treats the forecast like hype, they may be making a high-risk wager.

Timing is Everything: Dodd-Frank Rolled Out the FCPA Welcome Mat

The DOJ and SEC's growing FCPA enforcement focus on private equity is a natural evolution of the SEC's increased regulatory authority over advisers to private funds. The 2010 Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) required many previously exempt private fund advisers to register with the SEC, making them subject to SEC recordkeeping requirements and routine examination by the SEC's Office of Compliance Inspections and Examinations (OCIE) for the first time. Now the SEC is able to scrutinize private equity fund advisers more closely than ever before.[4]

The Makings of the Perfect Enforcement Storm: Access, Motivation and Institutional Resources

At the same time that private equity is facing increased scrutiny, FCPA enforcement is a priority on the rise. In 2010, the SEC created five national specialized units to focus on priority areas of enforcement.[5] These units included an FCPA Unit, as well as the Asset Management Unit charged with enforcing the securities laws against investment advisers to private equity funds, other private funds and registered investment companies.[6] Less than a year later, the SEC adopted the Dodd-Frank rules requiring private equity registration.[7]

The SEC moved quickly, and in October 2012 announced an initiative to examine newly registered advisers.[8] These "presence exams," were to be conducted over a two-year period and include reviews of high-risk areas including fund marketing and the allocation of fees, expenses and payments.[9] Concurrently, the SEC created a special unit within OCIE to lead these examinations, and set at its helm as co-chair a former member of the Enforcement Division's Asset Management Unit.[10]

It should not be surprising that with this institutionalization of dedicated resources, the SEC's examination of private equity fund advisers shows no signs of abating. On January 13, 2015, OCIE announced that in light of the high rate of deficiencies it observed, it would continue to examine advisers' handling of fees and expenses.[11]

Once Regulators Are in the House, They Tend to Wander: FCPA SWF Sweep

In January 2011, the SEC launched an investigative sweep into business dealings between major financial institutions, including private equity firms and foreign

sovereign wealth funds (SWF).[12] The SEC reportedly requested all documentation related to private equity fund advisers' work and relationships with SWFs since January 1, 2007, including information on specific assets managed by the advisers for the SWFs, specific financial services provided to SWFs and all FCPA compliance information (including internal policies, procedures and reviews).[13] In 2015, the SEC appears to be moving to Wells notices in some matters, indicating that the SEC staff has made a preliminary determination to recommend FCPA enforcement action.[14]

Once in the House, There May Be Reasons to Stay: Generating FCPA Investigations

The SEC's presence exams of newly-registered private equity fund advisers has reportedly resulted in other FCPA investigations as well. During the presence exams, OCIE identified "expense-shifting" and "hidden fees" as problematic practices in private equity. These practices involve an investment adviser directing private equity funds or their portfolio companies to pay the adviser's consultants or "operating partners" without sufficient disclosure to investors. On January 7, 2015, the New York Post reported that, while examining these allegedly hidden fee practices during examinations, SEC examiners identified possible FCPA violations and referred those matters for further investigation by the SEC's Enforcement Division.[15] The crux of the SEC's investigation appears to be examining whether private equity advisers may be indirectly paying foreign officials to secure business, and then shifting that cost to investors as a fee. There is no doubt that private equity fees will remain an area of focus for the SEC.

Once in the House, They Bring Their Friends: DOJ Joins for the "Princeling Investigation"

The SEC has also focused on financial institutions hiring practices relating to foreign nationals. It is well-known that the SEC began an FCPA investigation into financial firms for allegedly hiring the children of prominent Chinese officials in order to secure business and strengthen relationships with foreign officials.[16] This business practice is sometimes referred to as "princeling" hiring. Princeling hiring and its potential FCPA impact has been the subject of much debate since the SEC's probe began. Some argue that this practice does not give rise to FCPA liability since nothing "of value" is exchanged between the foreign official and the firm. Opponents highlight that "[v]irtually every [financial] firm has sought to hire the best-connected executives in China and, more often than not, they are…the offspring of the ruling elite.[17]

While the princeling probe originated in the SEC's anti-bribery unit, the DOJ has since joined the investigation, which now targets not only full-time employees, but also interns.[18]

Accordingly, financial firms, including private equity fund advisers, should exercise caution when hiring relatives of foreign officials. Even the appearance of impropriety in foreign hiring could subject a firm to a costly and time-consuming FCPA investigation, and possibly severe penalties.

Another Point of Entry for FCPA Enforcement Risk: Acquisitions & Joint Ventures

Private equity fund advisers may also incur FCPA risk through acquiring, or engaging in a joint venture with, companies that operate in non-U.S. markets. If a private equity fund adviser fails to conduct appropriate due diligence of an acquisition target, the private equity investor in the portfolio company may be held liable for the previous FCPA violations of the target under a theory of successor liability (if the alleged predecessor's acts of knowledge and participation were subject to FCPA jurisdiction), even if the acts occurred prior to the acquisition or if they were unknown to the purchasing firm. Therefore, it is critical that private equity fund advisers remain aware of FCPA risks across all portfolio companies.

Private equity fund advisers can mitigate FCPA risk from successor liability and post-acquisition third-party violations by instituting robust compliance procedures and comprehensive FCPA and anti-corruption due diligence.[19]

Through pre-transaction FCPA due diligence, private equity fund advisers must determine whether any joint venture partners, portfolio companies or other third parties present unreasonable risks of past potential violations or ongoing conduct that may become liabilities of the firm or its funds. Further, a robust compliance program is key to FCPA risk mitigation. Essential compliance elements include: initial and renewed due diligence protocols, representations/ warranties, certifications, training, audit rights and ongoing monitoring of third parties, contract termination provisions, implementation of accounting control systems and audit testing.

One More Dodd-Frank Gift: An Invitation to Your Employee to Visit the SEC and Get Paid

The increase in DOJ and SEC FCPA investigations and enforcement is further bolstered by the financial incentives of Dodd-Frank's whistleblower provision. After Dodd-Frank was passed, the SEC created a whistleblower provision that awards individuals who "voluntarily provide original information" that leads "to the successful enforcement of the covered judicial or administrative action" amounts equal to 10 to 30 percent of the monetary sanctions collected from the illegal activity.[20] In 2013, the SEC received a record 3,620 whistleblower tips and awarded one whistleblower $30 million for their FCPA tip.[21] With some FCPA settlements reaching hundreds of millions of dollars, the whistleblower program creates a powerful inducement to report allegations.

The Aftershocks of the FCPA Storm – Example: Civil Litigation

Since the FCPA enforcement uptick started in 2004, it hasn't stopped. Investigations of potential FCPA violations are costly and can result in significant financial penalties, disgorgement, criminal liability and even debarment from government contracts and bank funding (World Bank, EXIM, multi-lateral development banks). There are also collateral actions to consider including wire and mail fraud, money laundering (the FCPA is a predicate offense), Travel Act violations, commercial bribery allegations, foreign enforcement actions and litigation (including civil suits by foreign governments), business partner litigation, private RICO actions by competitors, stock-drop suits, derivative actions, whistleblower investigations and licensing suspension or revocation risks.

Let's start by examining just one of these risks: private civil litigation. Private litigants use the facts underlying alleged FCPA violations as the basis for civil lawsuits. These private lawsuits proceed on theories of common law fraud, civil RICO claims,[22] securities fraud class actions and shareholder derivative suits. For example, in 2008, a company owned by the Bahraini government filed suit against Alcoa, Inc. for allegedly paying nearly $110 million in bribes to Bahraini officials.[23] The action further alleged that Alcoa was bribing government officials by overcharging the government-owned company for raw materials.[24] Alcoa eventually settled the action brought by the Bahraini company for $85 million, in addition to paying a $384 million penalty to the U.S. government for its FCPA violations.[25]

One of the fastest-growing areas of FCPA parallel litigation is securities fraud class action lawsuits. An interesting example is the litigation involving Siemens AG. In 2008, Siemens AG, one of the largest engineering and electronics companies in the world, agreed to an $800 million settlement with the DOJ and SEC for alleged FCPA violations. Immediately following this settlement, a federal class action lawsuit was filed against Siemens. After motion practice, the court granted Siemens AG's motion to dismiss, finding that the complaint failed to allege facts sufficient to prove scienter under Rule 10b-5. Despite this outcome, Siemens AG no doubt incurred costly legal bills, the inconvenience of prolonged litigation and damage to its professional image in the United States and abroad.

Much like securities fraud class action lawsuits, shareholder derivative suits are also becoming increasingly common. For example, in *City of Brockton Retirement System v. Avon Products, Inc.,*[26] shareholders brought an action alleging that Avon's management issued materially false and misleading

statements about the company's compliance with the FCPA. While, in this action, the court ultimately dismissed the lawsuit, shareholder suits based on FCPA allegations are often extraordinarily costly to defend. Civil litigation represents yet another area of potential liability for businesses, including private equity fund advisers – another costly point of entry for FCPA risk if unabated.[27]

Time to Risk Mitigate: There's More Risk in Betting the House Than in Believing the Hype

Not ready to bet the house on the wager that FCPA enforcement in private equity is all hype? Don't think the regulator houseguests will leave quietly and without breaking something? Then the private equity industry should consider following the lead of the other industries that have hosted FCPA enforcement as prolonged houseguests, and mitigate its FCPA risk with risk-based, robust, targeted and tested compliance and due diligence programs. Then, whether it's a spring shower or hurricane, you are more likely to keep the roof over your head.

[1] TRACE, Global Enforcement Report (GER) 2013, at 15 (2014).
[2] Press Release, SEC, SEC Names New Specialized Unit Chiefs and Head of New Office of Market Intelligence, (Jan. 13, 2010); see also Andrew J. Bowden, Spreading Sunshine in Private Equity (May 6, 2014); "Why the Direct Access Partners Case Matters for Financial Sector Anti-Corruption Compliance," The FCPA Report, Vol. 2, No. 21 (Oct. 23, 2013).
[3] U.S. Sec. & Exchange Comm'n, FY 2015 Congressional Budget Justification, FY 2015 Annual Performance Plan & FY 2013 Annual Performance Report, at 1 (2015).
[4] See Investment Advisers Act of 1940, 15 U.S.C. § 80b-4; Rule 204-2, 17 C.F.R. 275.204-2.
[5] Press Release, SEC, SEC Names New Specialized Unit Chiefs and Head of New Office of Market Intelligence (Jan. 13, 2010).
[6] Id.
[7] See Press Release, SEC, SEC Adopts Dodd-Frank Act Amendments to Investment Advisers Act (Jun. 22, 2011). According to the Director of the SEC's Division of Investment Management, Norm Champ, as a result of these rule changes the number of SEC registered investment advisers increased more than 50% by the end of last year and now includes over 1200 private equity fund advisers managing approximately $2 trillion in assets. See Norm Champ, Remarks to the Practicing Law Institute, Hedge Fund Management Seminar 2014 (Sep. 11, 2014).
[8] Letter from Drew Bowden, Deputy Dir., Office of Compliance Inspections & Examinations, U.S. Sec. & Exchange Comm'n to Industry (Oct. 9, 2012).
[9] U.S. Sec. & Exchange Comm'n, Fiscal Year 2012 Agency Financial Report, at 12.
[10] Greg Roumeliotis and Sarah N. Lynch, Exclusive: SEC Forms Squad to Examine Private Funds, Reuters (April 7, 2014, 6:53 AM).
[11] OCIE Examination Priorities for 2015 (Jan. 15, 2015).
[12] Peter Lattman and Michael J. de la Merced, SEC Looking Into Deals With Sovereign Funds, N.Y. Times (Jan. 13, 2011, 8:37 PM). As one private equity fund adviser explained, the relationship between SWFs and private equity funds is attractive to both parties because SWFs "receive a steady inflow of capital from mighty rivers of cash – the proceeds from energy sales across the Middle East and other oil-rich countries and the recycling of surplus foreign currency reserves amassed by the fast-growing economies of Asia" – and those funds are "increasingly looking to deploy assets in higher-earning alternative investments, of which private equity funds are a prime candidate." See Bain & Company, Global Private Equity Report 2012, at 57 (2012). As a result, SWFs have been investing large amounts of capital into private equity funds. See e.g., Graham Elton, Bill Halloran, Hugh MacArthur and Suvir Varma, Sovereign Wealth Funds Could Be Private Equity's New Best Friend, Forbes (Jun. 19, 2012, 8:41 AM). The SEC's investigative sweep focused on whether private equity fund advisers paid placement agents and brokers to secure SWF investments. See Joshua Gallu, SEC Probes Financial Firms on Sovereign Fund Bribes, Bloomberg (Jan. 14, 2011, 6:59 PM).
[13] See generally id.
[14] See The Bank of New York Mellon's Jan. 23, 2015 SEC filing.
[15] John Kosman, SEC Probes Private-Equity Firms Over Alleged Bribes, N.Y. Post (Jan. 7, 2015, 2:12 AM).
[16] Emily Glazer, J.P. Morgan Discussed Pitfalls to 'Princeling' China Hiring in 2006, Wall St. J. (Oct. 23, 2014, 5:58 PM); "SEC Investigation of JPMorgan Hiring Practices Demonstrates FCPA Nepotism Risks," The FCPA Report, Vol. 2, No. 17 (Aug. 21, 2013).
[17] Andrew Ross Sorkin, Hiring the Well-Connected Isn't Always a Scandal, N.Y. Times (Aug. 19, 2013); "Friendly Relations? When Nepotism May Violate the FCPA," The FCPA Report, Vol. 1, No. 10 (Oct. 17, 2012).
[18] See Ben Protess and Jessica Silver-Greenberg, JPMorgan Tracked Business Linked to China Hiring, N.Y. Times (Dec. 7, 2013, 1:24 PM).
[19] See "How to Perform Effective FCPA Due Diligence in Private Equity Transactions and Strategic Mergers and Acquisitions," The FCPA Report, Vol. 2, No. 5 (Mar. 6, 2013).
[20] 15 U.S.C. § 78u-6.
[21] "Caldwell and Ceresney Push Companies on FCPA Compliance, Cooperation and Self-Reporting," The FCPA Report, Vol. 3, No. 24 (Dec. 3, 2014).
[22] Bribery and illegally laundering money constitute predicate offenses under federal RICO statutes.
[23] Aluminum Bahrain B.S.C. v. Alcoa Inc., 866 F. Supp. 2d 525, 527 (W.D. Pa. 2012).
[24] "$384 Million Alcoa Civil and Criminal FCPA Settlement Highlights the Risks of Third-Party Relationships," The FCPA Report, Vol. 3, No. 2 (Jan. 22, 2014).
[25] Id.
[26] No. 11 Civ. 4665, 2014 WL 4832321 (S.D.N.Y. Sep. 29, 2014).
[27] See "Avon Class Action Dismissal Illustrates Challenges of FCPA-Related Shareholder Derivative Suits," The FCPA Report, Vol. 3, No. 21 (Oct. 22, 2014).