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Private Equity

FCPA Compliance Strategies for Hedge Funds and Private Equity Firms

By Jennifer Banzaca

Given today's investment environment, with an unabated government focus on the private fund industry and significant opportunities developing in emerging markets, private equity fund managers are hard-pressed to ignore corruption risks in their businesses. Molo Lamken, together with The FCPA Report and The Hedge Fund Law Report, recently hosted a panel that addressed hot topics in FCPA enforcement and compliance for this industry. The panelists, including outside and in-house counsel, discussed, among other things: the current FCPA enforcement climate for private equity and financial services firms; strategies for mitigating the risk associated with third parties and service providers in high-risk countries; handling facilitation payments; self-reporting violations; and the importance of continuously monitoring compliance programs. See "Corruption Considerations for Private Fund Managers: An Interview with Molo Lamken Partner Justin Shur," The FCPA Report, Vol. 3, No. 11 (May 28, 2014).

Government Focus on FCPA Violations in the Financial Services Industry

The financial services industry is currently a prominent FCPA enforcement focus. In March of 2009, FINRA stated that FCPA issues are a priority in its examinations. The SEC has conducted industry-wide sweeps and has issued many financial services firms information requests regarding their dealings with sovereign wealth funds as well as their hiring practices. And the DOJ continues its FCPA investigations and indictments. See "What Private Fund Managers Must Know About FCPA Enforcement," The FCPA Report, Vol. 2, No. 25 (Dec. 18, 2013).

Andrew DeVooght, a partner at Molo Lamken, predicted that FCPA enforcement in general will increase in the coming year. The DOJ "is going to have an increased budget this year. They are also trying to step up and make more efficient their FCPA investigations and bring them to a resolution more quickly," he said.

DeVooght noted that both the DOJ and the SEC are scrutinizing the financial industry more intensely. "I think some of the recent enforcement activity has raised a lot of interesting challenges for private funds," he said. "There has been a lot of noise about FCPA in the financial services industry." See "Top DOJ and SEC Officials Discuss FCPA Enforcement Priorities and Mechanics," The FCPA Report, Vol. 3, No. 7 (Apr. 2, 2014).

Rita Glavin, a partner at Seward & Kissel, explained that "the SEC and DOJ have said they believe there is a lot going on in the financial services industry, particularly with hedge funds and private equity funds." She added, "With hedge funds, officials are looking at how hedge funds are raising money from sovereign wealth funds. In private equity, they are looking at firms that have invested in a bunch of portfolio companies in areas of the world that are known for corruption. Those portfolio companies always have to hire a local guy on the ground to secure permits and there inevitably would be money that changes hands."

Glavin believes that the focus on the industry stemmed from New York State Attorney General's Office (NYSAGO) investigations of funds. "In 2008 and 2009, the NYSAGO was doing 'pay-to-play' investigations and going after funds that were getting New York pension plans to invest in the funds and kickbacks were being paid to government officials associated with the funds," she said. "That laid the groundwork and focused the SEC Enforcement Division on the idea that when funds are raising money and want to get investments from sovereign wealth areas of the world, they have to be doing what went on in New York State."

In addition to the heightened focus on the financial services industry, enforcement may be stepped up due to increased whistleblower reports stemming from the incentives provided by Dodd-Frank, said Derek Cohen, a partner at Goodwin Procter. The financial services industry is "a heavily regulated industry, but certainly if you add a financial incentive, the idea is that there will be more whistleblowers." See "Key Takeaways from the 2013 Office of the Whistleblower Report," The FCPA Report, Vol. 2, No. 25 (Dec. 18, 2013).

Common FCPA Problems for Fund Managers

Stuart Barkoff, general counsel at Global Environment Fund, said that many private equity fund managers face similar FCPA problems. This is particularly true if funds are investing in emerging markets. See "How Private Fund Managers Can Manage FCPA Risks When Investing in Emerging Markets," The FCPA Report, Vol. 2, No. 1 (Jan. 9, 2013).

For example, Barkoff considers the FCPA to be one of Global Environment Fund's top three concerns when looking at new or existing investments. "As we're approaching investments, the FCPA is really at the top of the list with financial due diligence," he said. "Our sectors are ones that touch upon government, which is an area of principal concern," adding that third parties are also a significant source of concern. See "$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).

Additionally, he said, "What we're buying, you can't always get rid of easily. Investment, whether a majority or minority in Tanzania, India or China, is often extremely illiquid and hard to wipe your hands of if you don't like it. So, whether or not we like it, once we bought it we bought it," he said.

Brian Guzman, general counsel at Indus Capital believes "there are three ways this impacts hedge funds." First, "there is a fundraising concern, especially in non-U.S. jurisdictions," regarding "the depth and breadth of sovereign wealth funds," he explained. Companies raising money from such sources must consider both the FCPA and local law, Guzman said, and investigate whether there is bribery involved.

A second issue that raises FCPA concerns is "restructuring or advising portfolio companies on how to raise capital or structure themselves," said Guzman. "In the Asia-Pacific and emerging market areas, there is a lot more government interaction and input so there is more of a concern about how much you're directing or participating in an underlying company's activities," he said. The more control the fund managers have, the higher likelihood of FCPA liability if a bribe is paid by someone in the portfolio to a government official.

Third, hedge funds must consider "building, addressing and monitoring practical and useful compliance controls." See "Structuring FCPA Books and Records Controls to Withstand SEC Scrutiny Without Impairing Sales," The FCPA Report, Vol. 2, No. 6 (Mar. 20, 2013).

Risks Associated with the Conduct of a Portfolio Company

Whether a fund manager may be held liable for the actions of one of its portfolio companies often comes down to control, said Seward & Kissel's Glavin. She noted that factors that increase the likelihood of liability include having people at the board level of the portfolio company and the degree of control the bylaws give the fund. See "FCPA Compliance in Non-Controlled Joint Ventures," The FCPA Report, Vol. 3, No. 10 (May 14, 2014) (discussing "willful blindness"). The "willful blindness" or "conscious avoidance" theory also relates to third parties with which the fund does business, explained more fully below.

An FCPA investigation into a portfolio company – no matter what the result – can cause negative consequences for the fund. "With the private equity model being to put cash into a business, develop it and then sell it off for a profit, if there is an ongoing FCPA investigation, the private equity firm won't be able to sell the company at the end of the investment," Glavin warned. "FCPA cases often take several years to resolve. If there is a cloud hanging over a portfolio company, the private equity firm won't be able to sell it." See "Bilfinger Settlement Highlights the Long Tail and Loose Jurisdictional Requirements of Criminal FCPA Charges," The FCPA Report, Vol. 2, No. 25 (Dec. 18, 2013).

Barkoff noted that there are steps firms can take to manage this liability risk. "Make sure your employees are aware of the obligations," he said. "You have to make sure the employees know what the FCPA is and how it may coincide with or differ from local laws," he explained. "You also have to look at this from a portfolio standpoint and once you get the firm trained up fully, push that training down to the portfolio companies. We started with getting the senior executives trained on FCPA and from there getting anti-corruption policies put in at each of the portfolio companies. The ease of this will depend on our level of control at the portfolio company."

Managing Third-Party Risks

Third parties are a perennial source of FCPA risk across industries. In the financial services space, FCPA investigations have focused on sovereign wealth funds using private placement agents to broker deals or to raise capital. See "Compliance Leaders from Citigroup and Morgan Stanley Examine FCPA Risks and Solutions for Financial Institutions," The FCPA Report, Vol. 3, No. 10 (May 14, 2014).

Willful Blindness or Conscious Avoidance

Cohen explained that fund managers can be held liable for criminal acts if the third party or service provider is acting as the fund's agent within the course of their employment – even if the fund manager is not specifically aware of the third party's activities. "In the FCPA, there is a willful blindness standard, so if you hire someone to be the local person on the ground and you ignore the red flags, such as them asking for large commissions or they need you to secure them large gifts, then you run the risk of incurring some liability," Cohen said.

Ask Questions

To avoid such liability, Glavin tells clients that "if there is a company you want to use, hire someone to do due diligence on them, whether it's a law firm or consulting firm. Get them to fill out a questionnaire about the kind of business they are doing and sign a certification they are going to comply with the FCPA and they understand what it is. If you have a service provider that won't sign that, that's a huge red flag." See, e.g., "Sample Questions to Ask Third Parties When Initiating Anti-Corruption Due Diligence," The FCPA Report, Vol. 2, No. 20 (Oct. 9, 2013).

Monitor the Third Party

"You can't just stick your head in the sand," Cohen said. "Once you do your due diligence and have engaged a third party, there is an obligation to monitor the third party to make sure problems don't unfold." If the fund is investigated, "it won't be enough to say you began the relationship and things were fine. There is an ongoing obligation to make sure things stay that way. You have to have the proper internal controls in place because you're not going to continue to do the same sort of due diligence you did at the offset. If something goes wrong, you want to be able to say you set up reasonable controls but you missed a problem, why you missed it and what you've done to fix it to make sure it doesn't happen again." See "Davis Polk Lawyers and Morgan Stanley Compliance Director Discuss DOJ's Decision Not to Prosecute Morgan Stanley for FCPA Violations," The FCPA Report, Vol. 1, No. 10 (Oct. 17, 2012).

Detailed Invoices

"You want to make sure that when you're paying that service provider you get a detailed list of what you're paying for," Glavin said. "You don't just want to pay a lump sum of money into a strange bank account." Many would be "stunned to see that in some emerging markets the local guy that everyone goes to, in order to get permits and get stuff done, is paying people off or taking bribes." To avoid such a situation, "you have to run the traps. You have to find out who the guy is, why you're paying him and what the normal level is to be paid for that particular job and how you're paying him. You need to document all this," she said.

Risk-Based Diligence

It can be challenging to determine how much due diligence is enough. "The DOJ wants to see that you asked the questions about who you are dealing with, how they came to you, that you have done reference checks on them and if these people are connected with the local government," Glavin explained. "They want to know what your payment agreement is, what your contract with them says, what discussions you've had with them. The due diligence ranges based on the job,"

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she said. See "Lessons Learned by Motorola Solutions, ExxonMobil and VMWare on the Role of Risk in Designing and Implementing an FCPA Compliance Program," The FCPA Report, Vol. 2, No. 15 (Jul. 24, 2013).

Look at Bank Accounts

When conducting initial and ongoing due diligence on third parties and service providers, Cohen said firms should review all payments to third -party bank accounts. "You're looking for things that seem inconsistent with the business that is going on and payments in large sums or unusual sums. Basically, to use the technical term, you're looking for anything that would seem fishy," he said.

Include Reps and Warranties in Third-Party Contracts

Including anti-corruption reps and warranties in third-parties contracts can also decrease FCPA risk. According to Barkoff, "This is always a bit of a challenge for us. In the U.S., you get an 'FCPA rep' and a 'compliance with law rep' and everyone signs them," he said. However, "when you go into other countries, some people aren't familiar with the FCPA and they don't want to sign anything to comply with a U.S. law," he explained. "There is often an education process. We write into our term sheets that not only will the third party comply with the law but will comply with the FCPA and the Bribery Act and we will work with them to make sure they understand what that means in advance of making our investments," Barkoff said. See "Complying with the FCPA: Mergers, Acquisitions and Investment Transactions (Part Four of Five)," The FCPA Report, Vol. 2, No. 11 (May 29, 2013) (discussing contractual safeguards).

Training Third Parties

As a further protection, Barkoff said, "we have adopted a training program that we have people go through before we even come in so there is this continuity from before our dollars had even touched the company. We can say we addressed any issues before our money was there so there was an understanding." Barkoff's company also asks its third parties to sign certifications related to anti-bribery laws. "If you control a company, it's easy to force them to certify and if they won't, then you can [impose] appropriate consequences. But, if you're a minority investor, this can sometimes go south. You have to pick your battles sometimes."

Indus Capital's Guzman added that the government has made clear that one size does not fit all when it comes to third parties. "If something goes wrong, you have to sit across the table from the government and say you did everything you could," he said. "You need to think about what they will perceive as 'everything you could.' If the company or other party did not understand the FCPA and you provided training and oversight, it seems reasonable under the circumstances but there is no guarantee." If something goes wrong, you must be ready to explain it, he said.

Internal Controls and Bank Accounts

Cohen said the internal controls should be similar to those employed in accounting and auditing. "You want to know how these companies are booking these various payments and activities. If you retain a consultant, you want to know what that consultant is doing and if you have bills for services rendered," he explained.

Facilitation Payment Exception

Under the FCPA, "facilitation payments," or "grease" payments to a government official to expedite ministerial tasks, are not illegal. Such payments are illegal under other anti-bribery laws, however. See "A Comparison of Anti-Bribery Laws in the U.S., U.K. China, Germany and India," The FCPA Report, Vol. 3, No. 3 (Feb. 5, 2014). Companies are also increasingly concerned with the message being sent to employees and government officials alike when prohibiting bribes but making concessions for facilitation payments.

Many companies choose to prohibit all facilitation payments. Others recognize that there may be extenuating circumstances in which these payments are necessary and wish to reserve the right to allow them when the situation calls for them, such as when the health or safety of an employee is at risk. With this position, companies must implement strict and robust policies and procedures governing facilitation payments and have a clear process for employees to follow should the need arise to make a facilitation payment. See "Designing a Facilitation Payments Policy to Minimize Liability and Retain Flexibility (Part One of Two)," The FCPA Report, Vol. 1, No. 4 (Jul. 25, 2012), Part Two of Two, Vol. 1, No. 5 (Aug. 8, 2012).

Guzman said that distinguishing facilitation payments from bribes is "an interesting challenge," as is navigating cultural barriers and expected practices. He described a situation where Indus Capital dealt with a difficult situation. "Several years ago, we were doing due diligence and we had an initial meeting with a target company and a local facilitator who worked with the government," he said. "We asked for various documents and financial records and they came back and asked what set of financial records we meant. We responded that by definition there should just be one, but the company informed us there was a financial record the controlling family maintained for itself and one that is submitted to the local government to pay its taxes. That was a red flag for us."

When to Disclose a Potential Violation to the Government

Like any company, a fund that discovers a potential FCPA violation must consider whether self-disclosing that violation is appropriate. In making this decision, Glavin believes that "if you're a publicly-traded company, you have to disclose. The risks are too high not to." However, "with private companies and funds, I'm not usually in favor of disclosing." See "Audit Committee Responsibilities Before, During and After Internal Investigations: Remediating and Disclosing the Investigation to the Government and the Public (Part Four of Four)," The FCPA Report, Vol. 3, No. 7 (Apr. 2, 2014) (discussing the voluntary disclosure calculus).

To decide whether disclosure is appropriate, "we look at the scope of the problem and how many people know about it," Glavin said. "Is it a cancer that has metastasized throughout the company? If a lot of people know about it, it's more likely there could be a whistleblower," she noted. "Once you understand the scope of the problem, you have to clean it up immediately and do the training necessary and get the proper controls in place to prevent it from happening again. If you disclose, you're going to open yourself up to scrutiny so you want to make sure you have taken the necessary actions to correct the problem and to prevent it from happening again," she advised.

The problem with self-disclosure is the DOJ often doesn't want to stop at the reported problem, Glavin noted. "The government wants to know about other parts of your business to see if there are other problems or potential problems," she explained. Cohen concurred. "As a cooperator, you may end up benefiting in terms of the ultimate fine, but if you walk in and disclose a problem, the DOJ will ask for more information and want a further investigation of the issue that will end up costing you more. So, you may win on the fine but lose on the legal fees and other resources to conduct an investigation. If it's a public company, it's obviously a different calculus whether to disclose a problem. Either way, it's a very fact-specific decision and it's not an easy call. However, the DOJ has said that it wants to incentivize people to cooperate and come forward with FCPA violations."

Glavin believes a company's outcome may be the same regardless if it self-discloses. "I have not seen a tremendous difference between the companies that disclose and the companies that don't. If you've taken all the proper steps and cleaned things up and down the road the DOJ finds out about it and asks you about it, you're probably going to get hit just as hard as you would have if you had disclosed the problem."

The decision whether to self-report will also depend on where the company is headquartered. "If you're a foreign company that has some business in the U.S. and the DOJ can't get to you because their subpoenas don't apply abroad, I've recommended to those companies not to disclose," Glavin said. See also "When Should a Company Voluntarily Disclose an FCPA Investigation?," The FCPA Report, Vol. 3, No. 4 (Feb. 19, 2014).