FS Regulatory Brief

Anti-corruption laws: Private equity not exempt

Introduction

Over the past few years, there has been increased national and international attention directed at bribery and corruption related to business activities that involve government and pseudo-government entities and individuals. This heightened scrutiny has resulted in a greater focus by countries' regulatory and law enforcement agencies on the financial services industry, including private equity firms.

In the United States, the Foreign Corrupt Practices Act of 1977 (FCPA) sets the national landscape for anti-bribery laws. The FCPA is jointly enforced and prosecuted by the US Department of Justice (DOJ) and the US Securities and Exchange Commission (SEC). Both organizations have increased their pursuit of enforcement actions for FCPA violations, as well as their coordination. In 2010 the SEC's Division of Enforcement formed a special unit to focus on FCPA investigations. The DOJ and the Federal Bureau of Investigation (FBI) have also committed additional staff and resources to FCPA investigations. As Lanny Breuer, Assistant Attorney General for the DOJ's Criminal Division recently said "We are in a new era of FCPA enforcement, and we are here to stay."

As part of this heightened scrutiny, the federal agencies have been focusing on investment advisers, as exemplified by an SEC Division of Enforcement sweep letter issued in January 2011, which requested information concerning the relationship between major financial institutions (including private equity firms) and sovereign wealth funds. In addition, the whistleblower provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act will likely increase the number of complaints/tips concerning possible FCPA violations, increasing investigations into potential FCPA violations.

In addition to the increased attention in the United States, the international regulatory community has recently bolstered anti-corruption and anti-bribery efforts. In 2005, 140 countries signed the United Nations Convention against Corruption (UNCAC). Since then, many countries have expanded or re-examined their anti-corruption campaigns. For instance, on July 1, 2011, the UK Bribery Act went into effect, with a broader scope and more severe penalties than the FCPA. The Bribery Act could have a significant impact on investment advisers that have business operations or private equity holdings in the United Kingdom or that do business there.

Understanding anti-bribery regulation from both a US and international perspective is an essential element of an effective compliance program.

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Overview of FCPA rules

The FCPA, enacted in 1977, contains two major components: (1) the anti-bribery provision, and (2) the books and records requirement.

The anti-bribery provision

The FCPA's anti-bribery provision makes it unlawful to corruptly pay or offer to pay money or anything of value to a foreign official, a foreign political party, or a foreign political candidate for the purpose of retaining, obtaining, or directing business.

The FCPA applies to any individual, firm, officer, director, employee, or agent of a firm and any stockholder acting on behalf of the firm. US parent companies can also be held liable for the actions of foreign and domestic subsidiaries that are in violation of the FCPA.

The FCPA additionally addresses third-party payments through intermediaries. Since the FCPA prohibits corrupt payments made in the knowledge that all or a portion of the payment will go to a foreign official, disregard or ignorance by a firm regarding the actions of that firm's intermediaries is not an adequate defense. This is especially important for private equity firms as they can be held liable for the actions of their portfolio companies.

The books and records requirement

The FCPA also requires issuers to maintain accurate books and records, and have the appropriate internal accounting controls (see 15 U.S.C. § 78m(b) for further guidance). Since proving the payment of a bribe is a notoriously costly and lengthy process, enforcement organizations are focusing on the books and records requirement to identify potential violations. Having payments that are unexplained, not documented, or insufficiently detailed can raise concerns of potential violations.

Often, a violation of the FCPA's anti-bribery provision will additionally result in charges for violating the books and records requirements.

Penalties

Violations of the FCPA can carry both civil and criminal penalties including fines, disgorgement of profits, and imprisonment. In 2010, US enforcement agencies brought a combined 74 FCPA enforcement actions and assessed monetary penalties against corporations totaling $1.8 billion. In addition, eight of the ten largest settlements ever for FCPA violations have occurred since 2010. FCPA enforcement cases have also recently focused on prosecuting individuals - 35 individuals were charged in 2010, including senior corporate officers.

While no enforcement actions have been brought against private equity firms, we understand that the SEC may have current investigations underway concerning the activities of a foreign private company, which is a portfolio company of a US private equity fund. In addition, the SEC has brought FCPA cases against companies involving their acquisitions and joint ventures where the acquiring company holds a majority interest, with fines and penalties into the hundreds of millions of dollars.

Aside from the monetary penalties, which can be substantial, the reputational fallout from an FCPA prosecution can be long-lasting and devastating to an organization. In some cases, FCPA violations have caused companies to declare bankruptcy and dissolve.

Facilitation payments

As noted, the FCPA prohibits corruptly paying or offering to pay money or anything of value to a foreign official, a foreign political party, or a foreign political candidate for the purpose of retaining, obtaining, or directing business. It contains an exception that allows for "facilitation payments" (also referred to as "grease" payments). Payments that are designed to facilitate "routine government actions" from non-senior government officials are permitted. Such actions may include obtaining permits, licenses, or other official documents; processing government papers (visas and work orders); providing police protection; providing phone service, power, water supply, and mail pick-up and delivery; loading or unloading cargo; protecting perishable products; scheduling inspections; and allowing transit of goods across national

borders. Note, awarding new business or continuing business is not considered an exception.

Navigating the line between a facilitation payment and a bribe can be difficult and unclear. In fact, many organizations have taken the stance of banning facilitation payments altogether. Recent international legislation has mimicked this trend; the UK Bribery Act, for instance, does not provide an exception for these types of payments. Additionally, the Organisation for Economic and Co-operation and Development (OECD) has called for a worldwide ban on facilitation payments and has labeled them "corrosive."

It is also important to understand that while facilitation payments are permitted under the FCPA, many of the countries in which these payments occur regard them as illegal.

Key risks to private equity firms

The major FCPA risks facing private equity firms can be broken down into three categories: (1) risks associated with client solicitation (specifically sovereign wealth funds), (2) risks associated with making acquisitions and doing deals, and (3) risks associated with the actions of a portfolio company that the private equity firm controls.

Risks associated with client solicitation

In January 2011, the SEC sent information request letters to major financial institutions, including banks and several private equity firms, focusing on their relationship and fundraising efforts with sovereign wealth funds (i.e., foreign government-owned investment funds). These letters demonstrate federal regulators' concerns regarding the relationship between sovereign wealth funds and the financial services industry. Similar tactics were used in late 2009 when the DOJ made known that it was targeting the pharmaceutical industry — a warning that preceded an increase in the number of cases brought against industry firms.

Based on this trend, private equity firms should ensure they have the controls and practices in place to be prepared for increased scrutiny by regulators around how they obtain and retain their clients.

Risks associated with making investments

In terms of monitoring their own activities, private equity firms need to conduct a thorough review of the policies and procedures that are in place regarding the FCPA and the UK Bribery Act. In addition, compliance departments need to train and monitor the actions of their investment professionals, consultants, and staff and their interactions with foreign officials, both from the perspective of acquiring an ownership interest in foreign companies and from obtaining foreign market access (i.e., obtaining business permits, licenses, etc.).

A particular risk may be the gift and entertainment activities of personnel or affiliates. Compliance needs to train personnel with respect to these activities, and monitor these activities and transactions to ensure that gifts and entertainment are not directed toward government officials or government personnel. While the SEC and the Financial Industry Regulatory Authority (FINRA) have traditionally allowed for reasonable limits in these activities, the FCPA does not specify a minimum or de minimus dollar amount. Therefore, firms need to be diligent in their monitoring efforts as even relatively small gifts may violate the anti-bribery provisions if they are provided to an official for an improper purpose.

Risks associated with the actions of portfolio companies

The Dodd-Frank Act requires most private equity firms to register with the SEC as investment advisers and to comply with a host of regulations. Given the SEC Division of Enforcement's focused attention on the FCPA, it is increasingly likely that the SEC will inquire about FCPA controls during its examinations of registered investment advisers. Regulators may examine registered investment advisers' procedures around the FCPA, and may also seek to understand the procedures and actions of any agents or consultants of the adviser, as well as of controlled-portfolio companies.

It is also important to keep in mind that the federal courts have said that new parent companies, which could include private equity firms, may have successor liability. Under this

doctrine, private equity firms may be liable for both the pre-acquisition activities and ongoing activities of portfolio companies that they are deemed to control. If a portfolio company is found liable for FCPA violations, the private equity firm could sustain fines, loss of value, and potential loss in realized value if the portfolio company is sold.

While no private equity firm has yet been charged with an FCPA violation for the activities of a portfolio company, engaging in a thorough transaction due diligence is crucial for any private equity investment. Aside from the legal liability the firm could have for its investment, there is a reputational and business risk as well. For instance, if a potential acquisition had a series of questionable government contracts, or customers that seemed to be obtained through inappropriate means, the valuation and the corresponding purchase price of that entity could be impacted by any investigation. In addition, the fund and investors could be impacted by resulting fines and penalties. It is important to understand the value of (and coordination of) compliance and the business end of the firm when conducting this diligence. In addition, if it is determined that a portfolio company's FCPA policies are insufficient, the private equity firm should require that enhancements be made.

Leading practice controls

The increased global regulatory scrutiny and enforcement of the FCPA and other anti-bribery laws presents a clear call to action for financial services firms. Firms need to implement the appropriate controls, procedures, and training to mitigate against the risk of violations.

As we describe here, private equity firms have unique challenges, and should consider taking steps to address them. This will require business-wide coordination and buy-in, from senior leadership on down. The following are some of the leading practice controls that private equity firms should consider establishing.

- *Conduct a thorough risk assessment* of the firm's business, focusing on geographies, industries, and the use of consultants, sales agents, or placement agents. Certain countries and industries, for instance, tend to pose a higher risk of bribery concerns.
- *Conduct thorough pre-acquisition and post-acquisition due diligence of target acquisitions*, including compliance program reviews and transaction reviews of key contracts and customers. For instance, if a significant portion of a company's business comes from a government contract, your firm should understand and review how this work was obtained and is maintained.
- *Review and adjust the firm's anti-bribery policies against current industry trends and international laws*. The UK Bribery Act is a significant piece of legislation that private equity firms will need to assess and address in their specific businesses.
- *Address bribery, including the FCPA, as a key component of the firm's compliance training*, including specific examples of activities that could present risk, and the activities that are prohibited. This training should be provided not only to your employees but to any third-party consultants who could be at risk. The compliance function should maintain affirmations that this training has been completed.
- *Establish a point of contact to answer questions about prohibited and permitted conduct*. Also train employees and others on the internal reporting mechanisms for employees and others to report potential issues.
- *Take prompt action when a concern is identified*. Investigate promptly and thoroughly and take appropriate action when a concern is noted.
- *Regularly review the firm's policies and procedures regarding payments, as well as gifts, entertainment, and hospitality*, as these can be a major area of risk. A private equity firm should establish limits and approval requirements for these types of activities and transactions.

Additional information

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