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Financial Institutions

How Private Fund Managers Can Manage FCPA Risks When Investing in Emerging Markets

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Anti-corruption enforcement efforts have dramatically increased over the last few years. Every day it seems there is a new headline about an investigation involving alleged violations of the Foreign Corrupt Practices Act (FCPA). Disclosures in recent corporate filings and news reports show that a substantial number of companies, from pharmaceutical companies to Hollywood studios, are the subject of FCPA investigations. Indeed, the U.S. Department of Justice (DOJ) and the Securities and Exchange Commission (SEC) – the two government agencies responsible for enforcing the FCPA – have made clear that the prosecution of FCPA violations is a top priority. Federal authorities have also indicated that their enforcement efforts are increasingly focused on the financial services industry and, in particular, private fund managers that invest in emerging markets.

Given this heightened level of government scrutiny, it is important that private equity firms, hedge fund managers and other investors that conduct business in foreign markets understand the associated FCPA risks. Such risks can arise in the context of raising funds overseas, working with joint venture partners and third party agents, and investing in companies that operate in countries known for corruption. A potential misstep in these areas can result in a fund manager and its employees facing significant civil penalties and possible criminal prosecution or, at a minimum, having to respond to government subpoenas or requests for information in connection with an investigation by federal authorities, thus resulting in the unnecessary expenditure of time and money and the attraction of unwanted attention.

In an effort to help businesses comply with the FCPA, in November of last year, the DOJ and SEC jointly issued "A Resource Guide to the U.S. Foreign Corrupt Practices Act" (Guide). While the 120-page Guide breaks little new legal ground, it is a welcome development as it provides a helpful summary of the government's position on many important and recurring FCPA risks that arise for investors in emerging markets. This article considers some of those risks and offers practical guidance to help private fund managers and their employees avoid or minimize liability in this area.

Overview of the Foreign Corrupt Practices Act

The FCPA is a U.S. anti-bribery law that literally reaches around the world as it can subject a domestic fund manager to liability in the U.S. for activities conducted abroad. The statute contains two major provisions: (1) the anti-bribery provisions and (2) the accounting provisions.

This article primarily focuses on the FCPA's anti-bribery provisions. As is well known, the anti-bribery provisions prohibit bribery of foreign officials. In particular, the statute prohibits giving, offering or promising anything of value, directly or indirectly, to a foreign official with the intent to corruptly obtain or retain business. This prohibition applies to all domestic and, in some instances, foreign individuals and entities as well. As discussed below, under the FCPA's anti-bribery provisions, a private fund manager can be subject to liability based on the conduct of its employees, business partners and third party agents, and portfolio companies.

Pursuant to the FCPA's accounting or "books-and-records" provisions, companies are required to accurately describe all expenditures in their books and records. The accounting provisions also require companies to maintain internal controls designed to prevent payments prohibited by the anti-bribery provisions. While the FCPA's accounting provisions only apply to companies with securities registered on U.S. stock exchanges, they can still create liability for private fund managers, such as the private equity arm of a U.S. issuer or the manager of a fund with an investment in a domestic or foreign issuer.

The penalties for violating the FCPA can be severe. The statute provides that, for each violation, entities can be required to pay a fine of up to $25 million, and individuals can be incarcerated for up to twenty years. Other consequences of violating the FCPA can include disgorgement or the forced return of profits gained through the alleged bribery, debarment or suspension from doing business with government agencies, the risk of private lawsuits and reputational damage and the loss of good will. Given the magnitude of these sanctions and the recent enforcement spotlight on private funds, it is important that private equity firms, hedge fund managers and other investors carefully consider the FCPA risks of doing business in emerging markets.

Areas of FCPA Risk for Private Fund Managers

While there are numerous areas of pitfalls to be aware of, some of the most challenging areas for private fund managers investing in emerging markets include: (1) the provision of gifts, travel and entertainment; (2) the actions of joint venture partners and third party agents; and (3) the actions of portfolio and investee companies.

Liability for Provision of Gifts, Travel and Entertainment

The text of the FCPA is extremely broad as it prohibits corruptly giving or offering anything of value, regardless of its nature or value. U.S. authorities have interpreted broadly the statutory term "anything of value" to include gifts, travel and entertainment expenditures and other hospitality. This can present a challenge for private fund managers as the practice of offering such items can be an essential component of investing in emerging markets where gifts are often customary and part of the competitive terrain. This risk can arise in a variety of contexts as a manager and its employees may interact with government agencies when performing a wide range of activities, such as paying taxes, applying for permits, opening local bank or securities accounts and establishing local investment vehicles. On the establishment of investment vehicles in Ireland, see "Considerations for Launching Qualified Investor Funds in Ireland: An Interview with Pat Lardner, Chief Executive of the Irish Funds Industry Association," The Hedge Fund Law Report, Vol. 5, No. 31 (Aug. 9, 2012). On the establishment of investment vehicles in Luxembourg, see "How Can Hedge Fund Managers Use Luxembourg Funds to Access Investors and Investments in Europe, Asia and Latin America?," The Hedge Fund Law Report, Vol. 5, No. 27 (Jul. 12, 2012).

This risk can also arise when private funds invest in portfolio companies. While the FCPA is limited to improper payments to "foreign officials," this term has also been interpreted and applied broadly. "Foreign official," as defined by the

FCPA, includes officers or employees of an "instrumentality" of a foreign government. In the Guide, the DOJ and SEC reiterated their previously stated position that such instrumentalities include state-owned or -controlled entities, even if the government is not the sole owner of the entity and the business is performing a non-governmental function. See "U.S. Government Counters Foreign Official Challenge in the Eleventh Circuit," The FCPA Report, Vol. 1, No. 7 (Sep. 5, 2012). Thus, in countries outside the U.S. where the government is heavily involved in the private sector, employees of potential investee companies may be considered "foreign officials" and a manager's interactions with them could trigger liability under the FCPA.

When assessing this risk, however, it is important to remember that the FCPA does not prohibit corporate hospitality. The FCPA prohibits the payment of *bribes*, which includes bribes disguised as gifts, travel, entertainment or anything else. The question of whether a particular gift runs afoul of the FCPA thus turns on the intent of the gift-giver (i.e., whether the gift was *corruptly* offered or provided). Consistent with this principle, the Guide confirms that while modest business courtesies (e.g., taxi fare or promotional items of nominal value) are exceedingly unlikely to be deemed to evince corrupt intent, excessive or lavish gifts could potentially lead to an enforcement action. See "Top Practitioners Analyze the DOJ & SEC FCPA Guidance (Part One of Two)," The FCPA Report, Vol. 1, No. 13 (Nov. 28, 2012) (in particular, discussion under the heading: "Cups of Coffee and Taxi Fares").

The same standard applies with respect to the payment of business travel and entertainment expenses. Under the FCPA, such expenditures will not give rise to prosecution if they are reasonable, bona fide and directly related to the promotion, demonstration or explanation of products or services or the execution or performance of a contract. The Guide, for example, distinguishes between payment for a legitimate trip to inspect facilities in Michigan, for which business-class travel, moderate entertainment and meals are provided, and an illicit trip in which senior government officials travel first class with their spouses on an all-expenses-paid, week-long trip to Las Vegas, where the company has no facilities. In practice, however, it is not always that clear. For example, evaluating whether an expense that falls somewhere between a cup of coffee and a luxury vacation crosses the line can be a fact-intensive analysis that depends upon the circumstances of the particular case.

The potential exposure to liability for managers and their employees for the improper payment of gifts, travel, entertainment and other hospitality was illustrated by a recent government enforcement investigation. The news media reported in January 2011 that the SEC sent information requests to several financial institutions, including hedge fund managers and private equity firms, relating to their relationship with sovereign wealth funds (SWFs). Apparently the focus of the government's inquiry was whether the U.S.-based firms violated the FCPA by providing gifts and entertainment to employees of SWFs – who would likely be deemed "foreign officials" as SWFs are owned and operated by foreign governments – to induce them to invest with the firms. While no reported enforcement actions resulted from this investigation, managers that invest overseas would be well advised to keep this risk in mind when offering any form of corporate hospitality. See "The SEC's Investigation of FCPA Violations and Sovereign Wealth Funds – Implications for Hedge Funds," The Hedge Fund Law Report, Vol. 4, No. 4 (Feb. 3, 2011).

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Liability for Actions of Joint Venture Partners and Third Party Agents

It is also important for fund managers to be mindful that the FCPA prohibits giving or offering things of value directly or *indirectly* to a foreign official. Thus, as restated in the Guide, a private fund manager and its employees can be held liable for a bribe offered or made by a joint venture partner or third party agent as if the manager made the bribe itself. This is a significant risk for managers because corrupt payments by third parties form perhaps the most common basis for FCPA enforcement actions and such parties are often necessary for managers to locate, assess and secure investments abroad.

This FCPA risk is particularly acute as a manager can be liable for a bribe paid by an individual or entity working with or acting on behalf of the manager or one or more of its funds, even if the manager and its employees did not have actual knowledge of the bribe. Under the FCPA, proof of actual knowledge is not required to constitute a violation of the law. While mere negligence is insufficient, the FCPA's "knowledge" requirement can be satisfied if a manager employee is aware of a high probability that an improper payment will be offered or paid by a third party retained on its or its fund's behalf, and the employee deliberately insulates himself from suspicious actions or circumstances by not asking questions or looking the other way.

The government pursued this theory of liability – often referred to as "conscious avoidance," "willful blindness" or "deliberate ignorance" – in a notable FCPA prosecution involving charges against a hedge fund manager and a consortium of investors. In *United States v. Bourke*, bribes were paid to government officials in Azerbaijan to secure rights to participate in the privatization of a state-owned oil company. Frederic Bourke, who did not pay any of the alleged bribes but who was one of the investors in the deal, was indicted, went to trial and was convicted. At trial, prosecutors were not required to prove that Bourke actually knew about the improper payments, which were paid by a business partner.

Instead, the court instructed the jurors that if they concluded Bourke consciously avoided confirming suspicions he harbored that his business partner may have paid bribes, they may infer that he had knowledge of the illicit payments. This "conscious avoidance" instruction, which was affirmed on appeal, appears to have played a significant role in the jury's decision to convict Bourke. After the trial, the jury foreperson was quoted as saying: "We thought he knew and definitely *could* have known. He's an investor. It's his job to know." The government's reliance on this theory, and the court's willingness to uphold a conviction based on it, makes clear that an investor who has serious concerns about bribes being paid by a business partner or third party agent, but intentionally avoids learning the truth, is treated the same way as an investor who actually knew the illicit payments were being made.

Liability for Actions of Portfolio and Investee Companies

Private equity firms and hedge fund managers also need to be aware that, as with third party agents, the conduct of companies in which a fund is invested can expose the fund's manager to liability. While an investor's participation in the portfolio company's misconduct can expose it to FCPA liability, a private fund manager may also be held liable for an investee company's violation even if the manager and its employees did not participate in the illegal conduct nor have actual knowledge of it.

Under traditional agency principles, a portfolio company's knowledge of or involvement in illicit conduct may be imputed to the manager of the fund invested in that company. In the context of the FCPA and other areas of the law, it is well-established that foreign subsidiaries and their employees can be agents of a parent corporation thereby subjecting the parent to liability for their conduct. Under this legal construct, if a private fund sufficiently owns and/or controls an investee company, then the manager of that fund may be liable for FCPA violations by the company. Likewise, under the theory of successor liability – where a successor company inherits the acquired company's liabilities – under certain circumstances, fund managers can potentially be exposed to FCPA liability for a portfolio company's pre-investment conduct.

In assessing these risks, fund managers should consider the fund's relative degree of ownership and formal or operational control in the portfolio company. The DOJ and SEC's position is that greater ownership and control by a fund increases the likelihood that the fund's manager and its employees may come to know of, or may be willfully blind to, improper conduct at the portfolio company level. However, as made clear by the Guide, there is no precise level of ownership or control that triggers liability. In assessing whether a portfolio company is an agent of the fund or its manager for purposes of FCPA liability, the government considers not only the formal relationship between and among the entities, but also the practical realities of how they interact. Thus, a private fund manager could potentially be exposed to liability for violations by a company in which its fund holds a minority interest if, as a matter of practice, the manager participates in and maintains a certain level of control over the operations or management of the business.

Suggested Practices to Prevent or Mitigate Liability

To avoid or minimize the above-described risks, private equity firms, hedge fund managers and other investors should implement reasonable and appropriate anti-corruption compliance measures. While no compliance program can ever avert all improper activity, by being proactive and vigilant when it comes to anti-corruption efforts, fund managers and investors can mitigate liability or avoid it altogether. The Guide explains, and enforcement agencies have previously indicated, that an organization's compliance efforts are an important factor considered by federal authorities when determining what, if any, action to take in connection with an FCPA violation. Below are four important steps a manager can take to minimize potential exposure to liability.

1. Establish and Enforce Manager-Specific Policies and Controls

A private fund manager that plans to invest abroad should adopt formal, written policies that demonstrate its commitment to comply with the FCPA. These policies should be clear, concise and accessible to all employees. In addition to adopting a clearly articulated policy against all forms of bribery and corruption, a manager should institute meaningful anti-corruption controls, auditing practices and documentation policies with the goal of preventing and detecting misconduct. There is, however, no "check-the-box list" or one-size-fits-all approach. The Guide stresses that organizations should tailor their policies and controls to the specific corruption risks they face. Funds should also periodically review and update their anti-corruption policies and controls as their risk profile and the law in this area evolves. See "Comprehensive FCPA Guidance Provides a Roadmap for Companies to Reevaluate and Revise Their

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Compliance Policies," The FCPA Report, Vol. 1, No. 13 (Nov. 28, 2012).

2. Conduct Specialized Training

The Guide notes the importance of periodic, mandatory employee training. As with a manager's policies and controls, an employee training program should be tailored to the specific needs of the manager and updated as necessary. While the Guide does not specify how an organization should train its employees or what employees should know, at a minimum, employee training should cover a discussion of the FCPA and all other relevant anti-bribery laws, the manager's compliance policies and procedures, areas of risk specific to the manager, how to identify and prevent problems in those areas and practical advice to address real-life scenarios. Attendance at these training sessions should be documented and employees should be required to sign certificates of completion. For more on FCPA training, see "Training, Certification, Due Diligence, Customs Clearance and Facilitation Payments: An Interview with Leaders of Ernst & Young's Fraud Investigation & Dispute Services Practice," The FCPA Report, Vol. 1, No. 1 (Jun. 6, 2012). For more on hedge fund manager compliance training generally, see "Early and Often: Compliance Training Pays Big Dividends for Private Fund Advisers," The Hedge Fund Law Report, Vol. 2, No. 27 (Jul. 8, 2009).

3. Perform Risk-Based Due Diligence

An investor's anti-corruption due diligence is a critical step in minimizing FCPA risk. When considering a portfolio company investment, fund managers should conduct pre-investment due diligence, including, a review of the target company's financials, customer contacts and third party agreements; an audit of selected transactions; and an evaluation of the company's corruption risks and compliance efforts. A fund should also address any potential corruption issues identified during the pre-investment due diligence process. Such remedial steps may include deciding if certain employees, third party relationships or practices should be terminated and tightening controls and reporting requirements. Taking these appropriate pre-and post-investment due diligence steps will go a long ways toward avoiding FCPA liability and protecting the fund's investment. For more on best practices in pre-investment due diligence, see "Managing FCPA Risk in Cross-Border Mergers and Acquisitions," The FCPA Report, Vol. 1, No. 14 (Dec. 12, 2012).

Due diligence on prospective third party relationships is equally important. While the appropriate level and extent of review will depend largely on the risks specific to the proposed engagement, as a general matter, a manager should explore the business rationale for engaging the third party; evaluate the third party's qualifications and associations, including any relationships with foreign officials; and review the underlying contract to ensure that the payment terms are appropriate for the market, industry and services provided. Regardless of the level and extent of the review, for both portfolio companies and third parties, it is imperative that fund managers thoroughly document the due diligence process.

4. Implement Contractual Representations and Warranties

When negotiating with portfolio companies, business partners and third party agents, fund managers should consider FCPA-related representations and warranties in operating agreements, contracts and other relevant documents. While each situation will vary and, accordingly, each contract will differ, the agreement should generally contain provisions that:

- Expressly prohibit any form of bribery or corruption and require the contracting party to acknowledge that its owners and employees are aware of, understand and agree to comply with the FCPA and other applicable anti-corruption laws;
- Require the counterparty to undertake or cooperate with an investigation into potential violations and, if necessary, implement remedial measures;
- Allow the manager to terminate the agreement immediately upon sufficient evidence of an FCPA violation; and
- Provide the manager with indemnification for any FCPA liability stemming from the counterparty's conduct. See "Indemnification Provisions in Agreements between Hedge Fund Managers and Placement Agents: Reciprocal, But Not Necessarily Symmetrical," The Hedge Fund Law Report, Vol. 3, No. 41 (Oct. 22, 2010).

These anti-corruption measures, among others, can mitigate the likelihood of issues arising and can be critical in defending the manager against an enforcement inquiry. However, after the third party is retained or the investment deal closes, it is important for managers to remain vigilant in identifying and investigating red flags that might indicate corruption. See "Managing FCPA and Other Risks After Onboarding a Third Party," The FCPA Report, Vol. 1, No. 12 (Nov. 14, 2012).

If, at any point, the fund manager learns of information suggesting that an employee, third party agent or investee company has or is expected to engage in conduct that may violate the FCPA, the manager should be prepared to undertake an appropriate inquiry and, if necessary, take remedial action. See, e.g., "When, Why and How Should Companies Discipline Employees for FCPA Violations?," The FCPA Report, Vol. 1, No. 8 (Sep. 19, 2012). While a manager may not always be in a position to uncover or prevent corrupt payments (e.g., due to the manager's lack of control or ownership of a portfolio company), failure to make good faith efforts to do so can result in liability. As shown in the *Bourke* case, liability can be triggered where an investor was aware of certain warning signs indicating possible bribery and ignored them.

While there are several areas of FCPA risk for private fund managers that invest in emerging markets and multiple theories by which an enforcement action can be pursued, as made clear by the Guide, there is no hard set of rules to navigate these areas and, because the vast majority of FCPA cases settle, many of these theories have not yet been sufficiently tested in litigated matters. Thus, while there will continue to be difficult judgment calls about potential exposure to FCPA liability, by taking steps to prevent, detect and remediate corruption, investors can benefit from opportunities in emerging markets while managing these risks.

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