

Anti-Corruption Compliance for Private Equity and Hedge Funds

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Private Equity and Hedge Funds



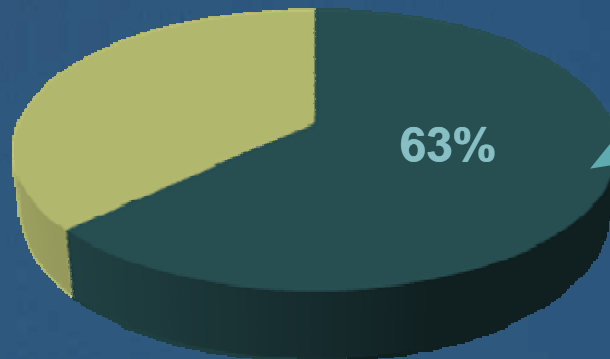
Anti-Corruption Challenges

Lingering political fallout from 2008-2009 financial crisis makes the financial industry an attractive target for anti-corruption enforcement.

- ◆ Neither private equity nor hedge funds have extensive history or experience in anti-corruption compliance.
- ◆ Private equity and hedge funds have focused investments on international companies which tend to have weak (or non-existent) anti-corruption compliance programs.
- ◆ Private equity firms have more robust policies than hedge funds for vetting management of companies for investment.
- ◆ Private equity firms are wedded to cost cutting strategies in their portfolio companies, but cannot do so at the expense of anti-corruption compliance.

Anti-Corruption Challenges

Deloitte 2011 survey of corporate executives, investment bankers, private equity executives and hedge fund managers, found that:



63 percent of respondents reported that the FCPA and anti-corruption issues caused their companies to renegotiate or pull out of planned business relationships, mergers or acquisitions over the last three years.

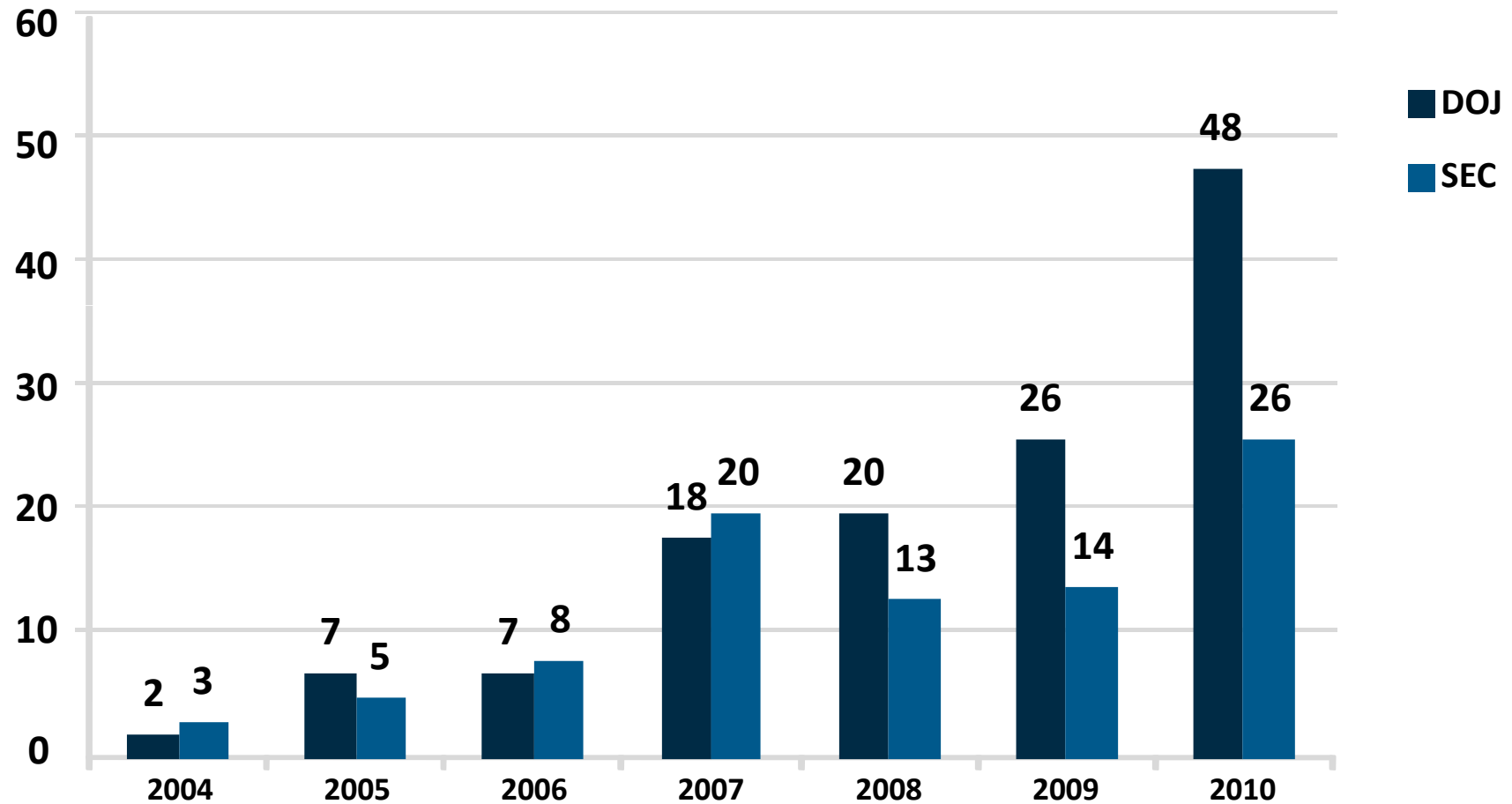


**FCPA
and
UK Bribery Act:
The Current
Enforcement
Picture**



FCPA: Increase in Enforcement Actions

2010 witnessed an 85% increase in FCPA enforcement actions over 2009, which itself was a record year.



FCPA: Enforcement Trends

Aggressive FCPA enforcement has resulted in corporate mega-fines:

- ◆ For 2010, fines total over \$1.6 billion
 - *more than half of all federal criminal fines collected.*
- ◆ Fueled by voluntary disclosures and industry-wide investigations
 - *oil, pharmaceuticals and medical devices, military and law enforcement equipment, and telecommunications.*
- ◆ FBI has dedicated FCPA squad which is using aggressive investigative tactics - *consensual recordings, ambush interviews, undercover officers, informants, search warrants and wiretaps.*
- ◆ SEC Dodd-Frank whistleblower bounty program will increase number of credible complaints, investigations and prosecutions.

FCPA: Whistleblower Bounty

- ◆ Whistleblower Bounty program offers rewards of 10 to 30 percent of any settlement over \$1 million. SEC's Whistleblower Office opened on August 12, 2011.
- ◆ SEC regulations have been adopted (pending appeal).
- ◆ SEC estimates it will receive 30,000 complaints a year; 1-2 credible complaints each day.
- ◆ With certain exceptions, whistleblowers must first file complaint internally with company and wait for 120 days before filing with SEC.
- ◆ Companies will increase self-reporting to pre-empt whistleblowers.



FCPA: Relevant Prohibitions

Private equity and hedge funds are subject to anti-bribery prohibition against:

Any payment, offer, authorization, or promise to pay money or anything of value to a foreign government official with a corrupt motive in order to obtain or retain business.

- ◆ “Anything of Value” means **anything** of value.
- ◆ “Obtain or Retain” business means a variety of types of business advantages (e.g. tax, customs).

FCPA: Relevant Prohibitions

Books and Records and Internal Controls

Private Equity and Hedge Funds are not **directly** required by the FCPA to keep accurate books and records and internal controls

- ◆ Private companies are not "issuers" for purposes of the FCPA
- ◆ Basic requirement for anti-corruption compliance program should include accurate books and records and system of internal controls
- ◆ Under the UK Bribery Act, accurate books and records and internal controls are an essential part of any "adequate [compliance] procedures."

Other Gifts of Value

FCPA:

- ◆ Gifts, meals, and entertainment can trigger violations (i.e. providing something of value to obtain or retain business).
- ◆ Affirmative defense for reasonable and bona fide marketing and promotional expenses directly related to (A) the promotion, demonstration, or explanation of products or services, or (B) the execution or performance of a contract with a foreign government or agency thereof.

UK Bribery Act:

- ◆ Hospitality must be “reasonable and proportionate.”

Interactions with Foreign Officials

Dealings with foreign representatives can violate FCPA, UK Bribery Act and other anti-corruption laws.

- ◆ In 2008, DOJ warned banks, investment banks, private equity and hedge funds to conduct due diligence of overseas investments to determine foreign government ties.
- ◆ Two district court decisions (Noriega and Carson) have upheld Justice Department position that officials at private companies which is “controlled ” by government entity are “foreign officials.”

Interactions with Foreign Officials

Representatives of Sovereign Wealth Funds and Foreign Public Institutional Investors are “foreign officials” under the FCPA and “public officials” under the UK Bribery Act.

- ◆ In late 2010 and early 2011, SEC initiated industry inquiry into anti-corruption compliance by banks, investment banks, private equity and hedge funds and focused on dealings with Sovereign Wealth Funds.
 - SEC inquiry letters issued to at least 10 entities.
 - Investigation later expanded to dealings with foreign public institutional investment funds.

Case Study: Goldman Sachs and Libyan Sovereign Wealth Fund

- ◆ In August 2011, SEC launched investigation of Goldman Sachs and its dealings with Libyan Sovereign Wealth Fund.
- ◆ SEC officials are interested in a \$50 million fee Goldman initially agreed to pay the Libyan sovereign-wealth fund as part of a proposal by the bank to help the fund recoup losses.
- ◆ The Libyan Investment Authority would have passed the \$50 million payment to an outside adviser, Palladyne International Asset Management, which was run at the time by the son-in-law of the head of Libya's state-owned oil company.
- ◆ The \$50 million payment was never made, but could still have violated FCPA since it was an "offer" to pay.

UK Bribery Act

SFO

Serious Fraud Office
www.sfo.gov.uk

Investigating and Prosecuting
Serious and Complex Fraud



Richard Alderman

Richard Alderman, Director of Serious Fraud Office, has warned private equity firms to “create a corporate culture of compliance” in companies owned, controlled, or invested in by the firm.

UK Bribery Act

Alderman outlined possible liability for private equity firms for:

- ◆ Failing to prevent bribery by an "associated" company, even where the private equity firm held less than a controlling interest in the company or only served on the board of directors of the company.
- ◆ Failing to prevent bribery by an “associated” company acquired by a private equity firm as part of its portfolio.
- ◆ Violating UK money laundering laws by receiving revenues from companies earned from illegal conduct even if such conduct was unknown to the firm.
- ◆ Providing hospitality to public officials which is embarrassing in size and scope.
- ◆ Structuring incentive payments to placement agents to ensure they are not used to bribe placement agents.

UK Bribery Act: Relevant Prohibitions

UK Bribery Act extends to non-UK companies that carry on a business or part of a business in the UK.

- ◆ Company is strictly liable for failure to prevent bribery of a foreign public official unless corporation establishes that it had “adequate [compliance] procedures” in place to prevent such bribery.
- ◆ Bribery prohibition applies to private and public interactions.
- ◆ Company must maintain adequate internal accounting controls as part of an “adequate [compliance] procedure.”
- ◆ Liability extends to persons **associated** with a commercial organization, which includes any person who “performs services for or on behalf of the relevant commercial organisation” (e.g. subsidiaries, employees, agents, JV partners, consortium members).

**Acquisitions:
Due Diligence
& Compliance**



Buying into an Anti-Corruption Violation

An acquiring company can be held liable for FCPA violations committed by a target company prior to the acquisition:

- ◆ **Alliance One:** \$4.2 million fine and \$10 million disgorgement for pre-acquisition FCPA violations.
- ◆ **Saipem:** \$240 million fine for conduct of an acquired subsidiary of ENI, Snamprogetti, where the FCPA violations occurred over 2 years prior to the acquisition.

NOTE: Not only may liability be inherited for a company's past actions through the concept of successor liability, but a firm may also be under fire for any ongoing consequences of corrupt acts, ***even if there is no direct evidence that the fund or its officers knew of the corrupt acts.***

Due Diligence of Target Companies

Basic Risk Assessment

(countries of operation, industry, extent of foreign government interactions)

Overall Compliance Structure

Prior History of Bribery or Internal Investigations

Internal Controls

Use of Third Party Intermediaries

Anti-Corruption Training

Employee Discipline/Hot-Line Reporting

Assessment and Review Procedures

Due Diligence of Third Parties

Private equity and hedge funds rely on third party placement agents to assist in investment and acquisition/sale business.

- ◆ Due Diligence of potential agents should be conducted to make sure that their dealings with public officials do not violate FCPA and with public and private officials do not violate UK Bribery Act.
- ◆ SFO Director Alderman has warned private equity companies do not bribe placement agents with excessive commissions and make sure that such commissions are transparent.

Due Diligence of Third Parties

Due diligence process of placement agents should include:

- ◆ Questionnaire which placement agent must complete.
- ◆ Background check to ensure no prior history of bribery or other crimes.
- ◆ Description of specific services to be provided, nature of compensation and payment method.
- ◆ Written contract should be executed, including:
 - Representations and warranties on compliance with anti-corruption laws;
 - Right to inspect and audit third-party books;
 - Right to terminate contract if believe violation has or will occur.

A Fast-Moving World

Post-Acquisition Compliance:

- ◆ Compliance does not end with closing.
- ◆ Compliance triage teams will be needed to work post-acquisition to ensure proper controls and compliance programs are adequately implemented.
- ◆ Compliance Integration Team ("CIT") must have authority and resources to bring an acquired company into the fold.
- ◆ Compliance mission must be adjusted depending on whether control is acquired, the relationship of the private equity company to the target company (passive versus active investor or manager), and the overall risk assessment associated with the target company.



Case Study: How Much Diligence is Required to Avoid Liability?

- ◆ Justice Department appears to have modified its policies governing pre- and post-acquisition due diligence requirements, relaxing its policy outlined in 2008 Halliburton Opinion Release (08-02).
- ◆ In Halliburton, Justice Department decided not to impose successor liability on Halliburton on condition that Halliburton complied with specified stringent conditions relating to due diligence, and reporting requirements.
- ◆ Halliburton was prevented by UK law from obtaining information from target company before the acquisition.
- ◆ In recent enforcement settlement involving Johnson & Johnson, Justice Department imposed “enhanced compliance” obligations which relaxed timing obligations on pre- acquisition due diligence and post acquisition FCPA compliance by newly-acquired companies.

What is at Stake?

**Violations
and
Liability**



Penalties for Violations

- ◆ **Criminal fines:** Corporate mega fines under FCPA or UKBA
- ◆ **Jail Sentences:** Officers, agents, consultants and managers
 - FCPA: 5 years for each anti-bribery and books and records violations; 20 years for each related money laundering count
 - UKBA: Individuals up to 10 years
- ◆ Stringent non-prosecution or deferred prosecution agreements
- ◆ Corporate monitors
- ◆ Debarment from government contracts
- ◆ Decreased portfolio valuations
- ◆ Director disqualification
- ◆ Reputational risks

Chain of Liability

For private equity and hedge funds, how far does chain of liability extend?

- ◆ Parent company liability can extend from company itself to subsidiaries, and down to portfolio companies depending on control of companies and nature of interest (general partners, limited partners, joint venture partners).
- ◆ Individual liability can extend to individual directors and officers depending on role they play in violating company. Director sitting on portfolio company board can be subject to criminal and civil penalties.
- ◆ Lack of knowledge of improper conduct will not protect private equity companies.

Chain of Liability

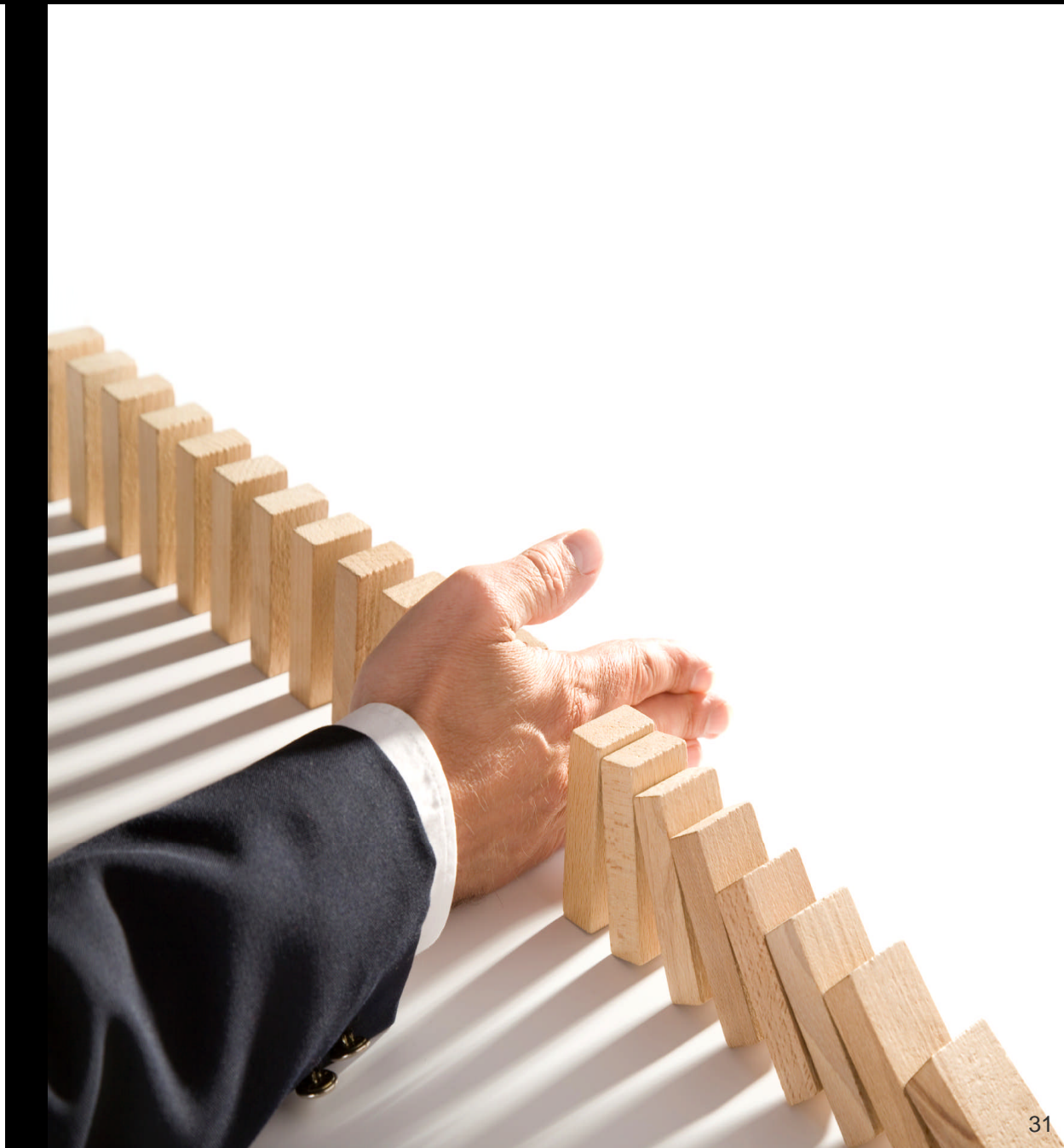
For private equity and hedge funds, how far does chain of liability extend?

- ◆ SEC has applied “control” liability theory to parent company and parent officers even though parent company had no knowledge of subsidiary illegal bribes (*SEC v. Nature Sunshine*).
- ◆ Aldermann has stated that UK Bribery Act will prohibit private companies from “benefitting” from bribery even if private equity company had no knowledge of improper payments.
- ◆ So-called “passive” investment will not protect private equity company from liability.

Case Study: Control Person Liability — Nature Sunshine

- ◆ In 2009, CEO and CFO of Nature's Sunshine, a manufacturer of nutritional products, were held responsible under books and records provision for bribes made by employees of a wholly-owned subsidiary in Brazil.
- ◆ SEC alleged that they had overall responsibility for the international operations of the company and that the people who would know about the relevant issues were under their control.
- ◆ This was the first time the SEC imposed liability on individuals under a theory of "control person" liability in an FCPA case. *Under that theory, the SEC may charge an individual who manages a company absent evidence that he or she knew about or participated in a bribery scheme.*

Compliance Programs



Market Now Requires Anti-Corruption Compliance

- ◆ Private equity and hedge funds now have to make sure that portfolio companies meet minimum anti-corruption compliance program requirements.
- ◆ Private equity and hedge funds need to implement anti-corruption compliance programs at every level and across all of its holdings.
- ◆ Absence of basic anti-corruption compliance programs across portfolio companies creates risk of prosecution of parent private equity and hedge fund companies as well as individual portfolio companies.

**Ability to buy and sell depends
on anti-corruption compliance.**

Basic Elements of Compliance Program

- ◆ Compliance policy and tone at the top
- ◆ Anti-corruption policies and procedures:
(gifts; hospitality, entertainment, and expenses; customer travel; political contributions; charitable donations and sponsorships; facilitation payments; and solicitation and extortion)
- ◆ Risk assessment
- ◆ Annual review and ongoing assessment
- ◆ Senior management oversight of compliance program and reporting access and obligation to Board

Basic Elements of Compliance Program

- ◆ Training program for anti-corruption compliance, including:
 - (a) training of all directors and officers, and, where necessary and appropriate, employees, agents, and business partners;
 - and (b) annual certifications, certifying compliance with the training requirements.

- ◆ Internal controls to identify and prevent bribery:
 - Internal audits must be supplemented with forensic audits since internal audits hinge on “materiality” and may not catch bribery schemes.
 - Every expenditure of money where bribery may occur should have specific controls and management procedures to prevent bribery (e.g. gifts and hospitality, review form for certain amounts and review by compliance and legal offices).

Basic Elements of Compliance Program

- ◆ Ongoing advice and internal reporting system:
 - Internet-based guidance and reporting systems;
 - Hot-line reporting system for employees to make anonymous reports.

- ◆ Disciplinary procedures to address violations of the anti-corruption policies and procedures.

- ◆ Due diligence procedures to review third party agents:
 - Inform foreign business partners of its Anti-Corruption compliance program;
 - Seek reciprocal written anti-corruption and anti-bribery commitments from its foreign business partners.

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