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SEC Corruption Probe Prompts Scrutiny Of Deals

By **Hilary Russ**

Law360, New York (February 17, 2011) -- In the wake of a U.S. inquiry into foreign bribery in the financial services industry, banks and private equity funds are putting the brakes on business deals in some of the globe's hottest markets as they make sure their transactions weren't brokered by corrupt sales agents overseas.

The anxiety began after news broke in mid-January that the U.S. Securities and Exchange Commission was looking into whether parts of Wall Street were entangled in foreign bribery when trying to solicit investments from government-controlled sovereign wealth funds in other countries.

Now, some firms have been delaying, renegotiating or repricing mergers, acquisitions and other deals as they take a harder look at their target companies and third-party agents, whom they hire to help gain access to some of the world's most corrupt countries with booming economies, such as Brazil, Russia, India and China, according to attorneys.

"There are going to be some deals that fall apart, unless you had counsel and parties that were attuned to this issue," said Michael Volkov, a partner at Mayer Brown LLP who has previously advised the World Bank in a review of its global corruption policies.

Unlike sectors such as oil and gas, pharmaceuticals, and medical devices, banks and private equity funds had never previously been the focus of a government sweep into possible violations of the Foreign Corrupt Practices Act, which prohibits U.S. companies from bribing foreign officials in order to get business.

In particular, regulators may now be looking at whether banks and private equity funds crossed the line when wooing investors by wining and dining agents of the sovereign wealth funds, who could be considered government officials.

They are also looking at what kinds of due diligence companies have done to root out FCPA issues before they close on a deal, attorneys said.

The genesis for the SEC's broad look into the industry likely came from a disclosure in February 2009 by Morgan Stanley, according to Claudius O. Sokenu, a partner at Arnold & Porter LLP who has represented an unnamed foreign brokerage company in an independent investigation related to possible FCPA violations, among other major cases.

Morgan Stanley revealed then that an internal investigation had uncovered likely FCPA violations by an employee based in a real estate subsidiary in China.

In its inquiry, the SEC first sent out informal letters instructing at least 10 recipients — reportedly including Citigroup Inc., Blackstone Group LP, Bank of America Corp. and Morgan Stanley — to preserve documents and asking them generally about their dealings with sovereign wealth funds.

Since then, the inquiry has deepened quickly, with several companies receiving subpoenas, a more formal, targeted measure in an enforcement effort, according to Palmina M. Fava, a partner at Paul Hastings Janofsky & Walker LLP.

The subpoenas don't name any specific foreign funds, but they ask firms for a broad range of documents. The companies are now working with the SEC to determine how to respond, according to Fava, who declined to identify any companies who had received subpoenas.

While no parallel criminal probe appears to have been launched yet, one could be coming, attorneys said.

The scare has caused companies to re-examine some deals in the works, with a particular eye toward successor liability that could leave a purchaser responsible for FCPA violations perpetrated by the company it bought.

Banks and private equity funds "are now on notice that if they do a deal and they don't do the right due diligence, they are on the hook for it," Sokenu said.

In response, companies are doing more due diligence that specifically looks for FCPA issues, and they're reviewing dealings with consultants and third-party agents in particular — those key operatives who help money managers get a foot in the door with sovereign wealth funds.

The danger for U.S. companies comes if those agents are either considered government officials or are bribing government officials themselves to secure access to deals, attorneys said.

"I've seen deals that were expected to close that were delayed because of this," Volkov said.

One multimillion-dollar transaction will be delayed by at least three months, and that deal isn't even controversial, Volkov said.

The target company in that case doesn't operate in any countries where corruption runs rampant. But the purchaser wanted to perform a more thorough due diligence review to make sure it wasn't acquiring a financial company with potential FCPA problems, Volkov said, declining to name the parties involved.

Some financial companies are now also taking a fresh look not just at their business with sovereign wealth funds, but at all of their international dealings.

Foreign corruption problems are not, of course, entirely new to U.S. financial firms looking for overseas deals.

After 9/11, they had to strengthen measures to weed out money laundering and make sure they weren't doing business illegally with sanctioned countries, and their efforts to uncover shady dealings have led them to renegotiate or abandon some deals, experts said.

But on FCPA issues, some financial buyers may have lagged behind, and the SEC's sweep has forced them to play catch-up.

In a survey released this month, Deloitte Financial Advisory Services LLP found that nearly two-thirds of the business professionals it interviewed had identified an FCPA issue or other compliance problem that caused them to renegotiate or terminate a transaction in the past three years.

The "Look Before You Leap" report surveyed 500 businesspeople at companies in the U.S., Canada and Mexico, with a particular focus on the financial services industry, including private equity firms, hedge funds and other financial buyers, as well as strategic buyers.

The top reason for a buyer to alter a deal due to FCPA concerns was a lack of transparency or an unusual payment structure in contracts, the report found.

But the survey also revealed differing levels of concern about FCPA risks between financial buyers and strategic buyers.

Private equity funds and other financial buyers were less concerned than strategic buyers about compliance issues — and less likely to renegotiate or pull out of a deal when due diligence identified problems.

Fewer than half of the financial buyers said they'd take such remedial action in that situation, as compared to more than 80 percent of strategic buyers.

That could be because strategic buyers — generally, companies already operating in the industry of the business they want to acquire — have ramped up their due diligence of transactions in the wake of increasing FCPA enforcement that has led to multimillion-dollar fines in certain industries.

But by the time Deloitte releases its next report on the topic, the SEC inquiry may have made the financial buyers more wary, according to Wendy Schmidt, the national leader of Deloitte's business intelligence services practice.

"[The probe] is going to extend the time it takes to do due diligence," she said. "FCPA-focused due diligence is really quite different than your traditional legal or financial due diligence. It's very specialized."

FCPA reviews of potential acquisitions include looking at documents and interviewing members of management for information about the company's anti-corruption policies and procedures, and how well those policies are enforced.

It's also critical for such reviews to examine the company's government interactions and touch points, payments made in dealings with government officials, licensing and registration of certain products, and patents, Schmidt said.

It's also important to identify government customers, agents, brokers and third-party operatives used in connection with deals, she and others said.

The survey also showed that many companies thought they were already doing an excellent job of ferreting out foreign corruption problems, but that may not always be the case, attorneys said.

"We often get involved with FCPA investigations, and what we do find is that the due diligence that was conducted was not very effective," Schmidt said.

"It's a real wake-up call to financial institutions and private equity firms that they're not immune to the reach of the FCPA," she said.

--Editing by Greg Ryan.

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