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Foreign Corrupt Practices Act

The SEC's Investigation of FCPA Violations and Sovereign Wealth Funds – Implications for Hedge Funds

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Although the Securities and Exchange Commission ("SEC") has said little publicly about its recent inquiry into potential Foreign Corrupt Practices Act violations involving the financial services industry and sovereign wealth funds, this sweep – which began earlier this month – has critical implications for U.S. private equity and hedge funds.

The SEC's Investigation

On January 14, 2011, The Wall Street Journal reported that the SEC launched an investigation to determine whether U.S. financial firms made unlawful payments in connection with obtaining or seeking to obtain investments from sovereign wealth funds – payments which might have violated the Foreign Corrupt Practices Act ("FCPA" or "Act").[1]

Sovereign wealth funds – such as the China Investment Corporation ("CIC"), which is responsible for managing part of the People's Republic of China's foreign exchange reserves,[2] or the Abu Dhabi Investment Authority, which channels Abu Dhabi's oil profits into investments[3] – are large pools of cash that governments draw from their reserves to make investments.[4] The SEC's investigation, although in an early stage, appears to focus on whether certain U.S.-based banks, hedge funds and private equity firms – either directly or indirectly – made illegal payments to employees or representatives of sovereign wealth funds. Investigators also appear to be focusing on whether U.S. firms improperly provided excessive entertainment or travel expenses to sovereign wealth fund employees.

The SEC's interest in this area is perhaps unsurprising given the rapidly rising tide of sovereign wealth fund investment in the U.S. in recent years. Sovereign wealth funds' increasing interest in investing in U.S. private equity and hedge funds has coincided with U.S. funds' increased need for cash inflows in the wake of the financial crisis.

In many ways, sovereign wealth funds are ideal candidates for private equity and hedge funds to court. Sovereign wealth funds typically have very large sums to invest and have long time horizons. Unlike pension funds, sovereign wealth funds do not have their own liabilities to meet, nor are they subject to withdrawals from external investors.[5] Recent data indicate that, as of 2010, more than a third of sovereign wealth funds were investing some portion of their cash in hedge funds.[6]

The FCPA and its Provisions

The FCPA prohibits payment, or the offer of payment, to foreign governmental officials in order to secure or retain business.[7] The SEC and the U.S. Department of Justice take a capacious view of who qualifies as a government official under the FCPA. The official need not be a head of state or government agency – any officer or employee of any foreign government-controlled entity, including a business venture, is covered by the Act. There is thus every expectation that a sovereign wealth fund employee will be treated as a governmental official for purposes of liability under the Act.

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Regulators have sought to give the FCPA's terms their broadest possible meaning and reach. Accordingly, simply because a payment may have been customary or vital to conduct business in the place where it was made is not a defense under the Act – the person making or directing the payment is liable under the FCPA even if he believed the payment to be legal or if the payment was solicited by the government official.

Nor must any payment actually be made to violate the Act – merely offering such a payment triggers liability. Moreover, the FCPA prohibits "indirect" bribery: payments made to a third party that a principal knows or suspects will be used to bribe a foreign official are illegal under the Act even if the principal has no direct knowledge of the payment,[8] and even where the third party is not a U.S. citizen.[9] Institutions are thus unable to "outsource" bribery to third-parties or foreign affiliates. "Willful blindness" is sufficient to establish a violation of the FCPA. This feature of the law is particularly relevant for U.S. private equity or hedge funds that engage "placement agents" to assist them in securing investments from sovereign wealth funds.

The Act includes two affirmative defenses: (1) that the payments were legal under the written laws of the country where made; or (2) that the payments constituted "reasonable and bona fide" promotional expenses incurred in the course of soliciting investment.[10] The DOJ and the SEC narrowly construe these defenses.

Over the last several years, the Department of Justice and the SEC have transformed the FCPA from a rarely used relic into a vehicle for increasingly expansive and effective investigations. Last year, more anti-bribery indictments were brought than in the previous seven years combined.[11] Foreign bribery investigations have become a priority for regulators, and penalties for violation of the Act are often severe. For example, Siemens recently agreed to a $1.6 billion settlement of FCPA charges; Halliburton agreed to pay nearly $600 million to settle allegations that it had bribed Nigerian officials in connection with natural gas contracts; and, last year, BAE Systems paid $400 million to settle an investigation into questionable payments to win contracts.[12]

Under What Scenarios Are Hedge Funds Exposed to FCPA Risks?

U.S. based funds that solicit any investment from overseas entities that are owned or controlled by foreign governments, including sovereign wealth funds, should pay close attention to the SEC's recent investigation and should carefully consider potential exposure to FCPA liability. The number of U.S. funds that fall into this category has seen explosive recent growth.

The CIC, one of the largest sovereign wealth funds in the world, recently announced that it would channel up to $6 billion into hedge funds worldwide, and a recent study showed that half of the sovereign wealth funds with active interests in hedge funds made their first investment in that asset class fewer than five years ago.[13] Under these emerging circumstances, hedge funds must be mindful of the common scenarios that present FCPA risk.

Concerns about running afoul of the FCPA should be front and center when employees of a U.S. fund directly solicit investment from sovereign wealth funds. Because all sovereign wealth funds are government owned and operated, all sovereign wealth fund officials and employees qualify

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as foreign officials for purposes of the Act. If a U.S. fund commonly engages in such solicitation, it is imperative that the fund have in place rigorous internal controls to ensure that solicitation of sovereign wealth funds not lead to potential liability. These controls should include, among other guidelines, strict rules regarding gifts and travel expenses paid to representatives of potential sovereign wealth fund investors, since there is no minimum threshold for what constitutes bribery under the Act.

The use of placement agents by U.S. funds may raise the greatest concern in the context of the FCPA, since the placement agents' actions are often not under the direct supervision of U.S. funds. Hedge funds that operate to solicit investment abroad should tread carefully when considering partnering with local individuals or entities that claim they can expedite or cut through red tape because of their relationships with local bureaucracy.

When a U.S. fund does employ a placement agent to solicit investment from sovereign wealth funds or state-owned pension plans, the intermediary's actions may be imputed to the fund or manager if regulators determine that the fund or manager had knowledge that the agent intended to violate the Act or "red flags" were present such that proceeding with the relationship was reckless.

To take a hypothetical, assume that a placement agent engaged by a U.S. hedge fund to solicit sovereign wealth fund investments requests an unusually large discretionary fund. This fact alone may or may not be enough to raise red flags. If the agent is seeking to operate in a country that is considered "high risk" (numerous resources are available to identify such countries, including information published by the U.S. Departments of State and Commerce[14]), the fund's chances of avoiding liability should the agent proceed to make unlawful payments will be diminished. Such a situation may present a quandary for a fund that both wishes to secure the potential investment and also stay on the right side of the line vis-à-vis anti-bribery laws.

Accordingly, when U.S. fund managers do employ placement agents to solicit investment from sovereign wealth funds, the managers should carefully vet such agents and require even thoroughly vetted placement agents to undertake steps to insulate the fund from liability. For example, the fund should obtain strong contractual representations and warranties from the third-party agent mandating compliance with U.S. and other anti-bribery statutes, carefully proscribe the agent's authority to act on behalf of the fund, and require regular sworn certifications from the agent attesting to compliance with the FCPA. Requiring the placement agent to disclose any relationships its principals have with government officials in the countries in which it operates is also advisable.

While this list of potential measures may be a good start, it is by no means exhaustive. Funds concerned that any or all of the issues raised above may be implicated by their business should be proactive about seeking out qualified counsel to assess the fund's current policies and procedures and provide advice on how better to ensure that any interaction with sovereign wealth funds proves profitable rather than costly.

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[1] See Dionne Searcey & Randall Smith, "SEC Probes Banks, Buyout Shops Over Dealings With Sovereign Funds," The Wall Street Journal, Jan. 14, 2011.

[2] See China Investment Corporation official website, available at http://www.china-inv.cn/cicen/.

[3] See Sovereign Wealth Fund Institute, "Abu Dhabi Investment Authority," available at http://www.swfinstitute.org/swfs/abu-dhabi-investment-authority/.

[4] See generally Sovereign Wealth Fund Institute, "About Sovereign Wealth Funds," available at http://www.swfinstitute.org/swf.php.

[5] Hedge Fund Marketing.org, "Sovereign Wealth Funds Investing in Hedge Funds," June 1, 2010, available at http://www.hedgefundmarketing.org/sovereign-wealth-funds-investing-in-hedge-funds/.

[6] Id.

[7] See 15 U.S.C. § 78dd-2(a).

[8] Id.

[9] Id. at §78dd-3(a).

[10] Id. at §78dd-2(c).

[11] See Mark Brzezinski, "That Bribe Could Be Costly," New York Times, Nov. 10, 2010.

[12] See Alain Sherter, "SEC Bribery Probe Opens New Front on Wall Street Corruption," BNET, January 14, 2011, available at http://www.bnet.com/blog/financial-business/sec-bribery-probe-opens-new-front-on-wall-street-corruption/9689.

[13] "Sovereign Wealth Funds Investing in Hedge Funds," supra note 5.

[14] See, e.g., U.S. Department of Commerce, "Transparency and Anti-bribery Initiatives," available at http://www.ogc.doc.gov/trans_anti_bribery.html; U.S. Department of State Archive, "Corruption and Bribery," available at http://2001-2009.state.gov/e/eeb/cba/gc/index.htm; U.S. Department of State Archive, "Doing Business in International Markets," available at http://2001-2009.state.gov/e/eeb/cba/index.htm; "Corruption Perception Index 2010," Transparency International, available at http://www.transparency.org/policy_research/surveys_indices/cpi/2010/results.