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SEC Launches FCPA Probe of Financial Services Industry's Interactions with Sovereign Wealth Funds

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Background

The U.S. Securities and Exchange Commission ("**SEC**") has, to our understanding, delivered letters of inquiry to at least 10 hedge funds, banks, and private equity firms requesting information about the firms' interactions with sovereign wealth funds ("**SWF**"). That list may expand to include other financial institutions. The investigation appears to be driven by: (i) the SEC's opinion that SWF employees are foreign government officials for purposes of the Foreign Corrupt Practices Act ("**FCPA**"); and (ii) reports that certain hedge funds, banks, and private equity firms may have paid bribes to those government officials to attract or retain business.

The SEC Launches an Industry Sweep

The SEC's use of inquiry letters, delivered simultaneously to a number of financial institutions, signals the launch of a broad investigation into the financial services industry's interactions with SWFs. In the past, the SEC and the U.S. Department of Justice ("**DOJ**") have conducted industry-wide sweeps designed to leverage their enforcement powers across multiple companies.[1] These sweeps usually target a core group of market participants– often initiated by inquiry letter requests – with the expectation that other industry players will then voluntarily investigate and self-report their own issues, and then enhance programs and controls in the relevant areas. In recent years, DOJ and SEC sweeps have targeted many of the largest multinational companies in the pharmaceutical, oil and gas, and engineering industries. For example, the DOJ and SEC currently are conducting an FCPA sweep in the pharmaceutical industry, in which they have sent request letters or initiated investigations of the largest multinational pharmaceutical companies. And during the same time, the costs of FCPA cases have been climbing – in 2010, eight of the ten largest FCPA cases in history were settled by companies that were required to pay over $1.5 billion in criminal fines and civil penalties.

[1] Although the DOJ has not announced yet any investigation into interactions with SWFs, the DOJ and SEC generally coordinate their law enforcement activities and have been doing so to a greater degree under SEC Enforcement Director Robert Khuzami, a former federal prosecutor.

Although the SEC has not publicly explained the catalyst for its SWF investigation, we believe this enforcement effort may have been launched to conduct further inquiry into certain types of transactions and business practices, including:

- The capital investments by SWFs in U.S. banks during the financial crisis;
- Redemption practices of certain funds and special investment vehicles during the financial crisis;
- Sales practices during the financial crisis for collateralized debt obligations ("**CDOs**") that may have targeted SWFs;
- New financial activity in the Asian market, particularly activity relating to IPOs; and
- Direct transactions over the last few years with the largest SWFs, such as those sponsored by the governments of China, Singapore, Abu Dhabi, Saudi Arabia, and Norway.

It is expected that the SEC will examine the firms' transactions and business practices to determine whether anything of value was provided to SWF employees to improperly obtain business or otherwise gain an unfair advantage.

The SWF FCPA Investigation

The jurisdictional reach under the FCPA of the SEC's SWF investigation extends to "issuers" -- companies which have registered securities or which are required to file reports with the SEC -- and the officers, directors, employees and agents acting on their behalf.[2]

The DOJ's jurisdiction under the FCPA is broader, and is not limited to issuers and those acting for them. If the DOJ should determine to pursue its own FCPA-based investigations of interactions with SWFs, its jurisdiction can extend to other financial services firms such as hedge funds and private equity firms that are neither publicly traded nor registered with the SEC. This is because the DOJ has jurisdiction under the FCPA to prosecute the offer, payment or authorization of the offer or payment of bribes to government officials by "domestic concerns." The term "domestic concern" is defined as including "a citizen, national, or resident of the United States" and "any corporation, partnership, association, joint-stock company, business trust, unincorporated organization, or sole proprietorship which has its principal place of business in the United States, or which is organized under the laws of a State of the United States or a territory, possession, or commonwealth of the United States."[3] Accordingly, any financial institution that is incorporated in a US state, or which has its principal place of business in the US, is within the jurisdiction of the DOJ.

[2] 15 U.S.C. § 78dd-1 (a).

[3] 15 U.S.C. §§ 78dd-2 (h) (1) (A) and (B).

In addition, the Department has jurisdiction to pursue persons *other* than issuers and domestic concerns, where such persons – including non-US financial institutions – or anyone acting on their behalf, while in the territory of the United States, offer, pay or authorize the offer or payment of bribes to government officials.[4] It should also be noted that the actions of US issuers and domestic concerns, and those of its officers and employees who are US citizens or nationals, in furtherance of the bribery of foreign government officials -- wherever in the world they are committed -- may be prosecuted under the FCPA's alternative jurisdiction provisions. Finally, the DOJ may under certain circumstances charge commercial bribery under the Interstate Travel in Aid of Racketeering statute, 18 U.S.C. §1952, should it determine that a bribe recipient, or intended recipient, was not a foreign government official.

The FCPA prohibits the corrupt influence of foreign officials, which it defines broadly to include "any officer or employee of a foreign government or any department, agency, or instrumentality thereof, or of a public international organization, or any person acting in an official capacity for or on behalf of any such government or department, agency, or instrumentality, or for or on behalf of any such public international organization."[5] In the current investigation, the SEC may be taking the position that SWFs are "instrumentalities" of their respective foreign governments and, accordingly, their managers and employees would be considered foreign government officials under the FCPA.

Under this theory, some common industry practices could trigger potential FCPA exposure for firms and individuals interacting with SWFs. Past FCPA sweeps have focused on *quid pro quo* exchanges involving excessive travel, entertainment, and high-value gifts provided to employees of government-controlled entities and their families. In the financial services industry, gifts and hospitality provided to SWF employees that meet marketplace standards, but which are perceived as excessive by the SEC or DOJ, could create FCPA exposure. Previous industry sweeps also have examined the use of middlemen who interact with foreign government officials on behalf of their principals. Here, the use of intermediaries and agents in conducting business with SWFs is likely to generate suspicion that potentially improper payments to SWF employees are being concealed within third party commissions or fees.

In addition to these general FCPA risks, industry-specific risks also are likely to be examined, including:

- Sales and marketing practices of U.S. banks in connection with CDOs, and whether firms alerted SWF employees of problems with CDOs before telling other clients;
- Giving SWFs priority over other clients in redemptions at funds that faltered during the crisis;

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[4] 15 U.S.C. § 78dd-3, et seq.

[5] 15 U.S.C. § 78dd-1(f).

- Favoring managers of SWFs over other investors in terms of providing information, paying commissions, and providing unusual discounts, all of which could be considered kickbacks; and
- Providing commercial advantages that benefited employees of SWFs in terms of their compensation or performance incentives.
- IPO book building practices and private placements, particularly in Asia, that may have improperly favored SWFs or provided other unlawful payments or promises thereof;

In each case, the SEC presumably would argue the "*quo*" received by the firm from the improperly-influenced SWF employee were further purchases of financial products by the SWFs using government-controlled funds.

Next Steps

Banks, hedge funds, private equity firms, and other financial services firms who interact with SWFs should move aggressively to undertake proactive steps to minimize their FCPA exposure. First, assess your institution's compliance systems to ensure that they properly manage FCPA risks in interactions with SWFs and their employees. Confirm the implementation of robust controls, including employee training programs, that are designed to prevent and detect improper transactions with SWF employees. Second, conduct a review of past SWF interactions to identify any issues that require further investigation or self-reporting, particularly with the threat of more whistleblowers in the wake of the new bounty program under the Dodd-Frank Act. Use the results of these audits to perform a gap analysis of your company's controls and determine whether further enhancements are necessary. The DOJ and SEC have stated repeatedly that they expect firms to undertake these types of reviews to ensure compliance with the FCPA, and that companies that do so will receive credit from the government.

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