VIGOROUS FCPA COMPLIANCE PROGRAM AVERTS U.S. ENFORCEMENT ACTION AGAINST FINANCIAL SERVICES FIRM FOR ROGUE EMPLOYEE VIOLATIONS

The U.S. Department of Justice (the "DOJ") and the Securities and Exchange Commission (the "SEC") recently declined to bring enforcement actions against a well known financial services firm and its fund business for violations of the Foreign Corrupt Practices Act (the "FCPA") in connection with significant foreign bribes paid by a former managing director of the company's real estate investment and fund advisory business in China. While the government charged the former managing director with FCPA violations, the government notably declined to charge the firm, Morgan Stanley, with any wrongdoing due in large part to the company's established system of internal controls and its continued efforts to enforce its anticorruption policies among company employees, including the individual who was charged in the government's civil and criminal cases.

This development is significant because Morgan Stanley appears to have benefitted from having a reasonable compliance system pursuant to which it uncovered a potential FCPA violation, terminated the culpable employee, reported the activity to the U.S. government, and cooperated with the ensuing investigations. As discussed below, the SEC and DOJ releases on their enforcement actions against the company's former director provide color as to what federal regulators consider to be an effective compliance program and an appropriate response to a potential FCPA violation. However, the case also underscores the general perils to private equity and hedge funds as well as other financial firms launching operations in emerging market countries with varying local standards of commercial behavior and attempting to manage the business practices of employees operating far from the company's home base.

Facts of the Case and the Government Settlements

The SEC alleged that former Morgan Stanley managing director Garth Peterson violated the FCPA and investment adviser laws by secretly acquiring, through self-dealing, millions of dollars of real estate investments from a Morgan Stanley fund that he managed for himself and the then-chairman of a Chinese state-owned entity with influence over the success of Morgan Stanley's real estate business in China. The Chinese official in turn steered business to Morgan Stanley's investment funds while personally benefitting from such business.

The SEC's civil action charged Peterson with foreign bribery, circumvention of Morgan Stanley's corporate internal controls, and aiding and abetting violations of the fraud provisions of the Investment Advisers Act (the "Advisers Act"). In April 2012, Peterson agreed to a settlement of the SEC's charges under which he will be permanently barred from the securities industry and required to disgorge more than $250,000 wrongfully obtained through his conduct, relinquish the real estate interests implicated in the SEC action, and pay civil fines pursuant to the Advisers Act and the Securities Exchange Act of 1934.

The DOJ charged Peterson with conspiracy to evade the internal accounting controls required of Morgan Stanley by the FCPA. Peterson pleaded guilty to this charge in April 2012 and faces maximum penalties of up to five years in prison and a fine of up to $250,000 or twice his gross gain from the offense. Sentencing is expected on August 20.

Elements of an Effective Compliance Program

The Peterson enforcement actions demonstrate that financial services firms and other multinational companies operating in foreign markets can protect themselves from FCPA liability for the acts of a rogue employee. Indeed, the DOJ specifically stated that it declined to prosecute Morgan Stanley because the company "constructed and maintained a system of internal controls, which provided reasonable assurances that its employees were not bribing government officials."

Specifically, the SEC and DOJ cited with approval the extensive compliance efforts of Morgan Stanley, which included:

- At least seven anticorruption trainings provided to Peterson specifically and a total of 54 trainings for Asia-based personnel over the course of six years;

- Internal policies, which were updated regularly to reflect regulatory developments and specific risks, that prohibited bribery and addressed corruption risks associated with the giving of gifts, business entertainment, travel, lodging, meals, charitable contributions, and employment;

- Annual employee certification of compliance with Morgan Stanley's policies;

- Specific instances on multiple occasions in which Morgan Stanley required Peterson to certify his compliance with the FCPA;

- Required disclosure by Peterson and other employees of their outside business interests;

- Policies and procedures for due diligence regarding foreign business partners and for approval of payments made in the course of Morgan Stanley's real estate business;

- Advice to Peterson regarding the status of employees of the Chinese official's state-owned business as government officials under the FCPA;

- At least 35 FCPA compliance "reminders" to Peterson during the relevant period, including online distribution of the company's policies and Code of Conduct, reminders regarding the company's policy on gift-giving and entertainment, and guidance regarding engagement of consultants and other high-risk transactions;

- Regular monitoring by Morgan Stanley compliance personnel of transactions, and audits and testing of particular employees, transactions, and business units; and

- Termination of Peterson's employment for the conduct described in the DOJ and SEC charging documents.

Risks Associated with Financial Services Businesses in Foreign Markets

The facts of the Peterson enforcement actions demonstrate the recurring compliance challenges faced by U.S. financial services firms and other multinational companies operating in foreign markets. These challenges arise in part from the necessity of obtaining government licenses and approvals, which may require the assistance or intervention of local third parties, and identifying the possible government affiliations of business counterparties. Other FCPA risks include potential liability for the actions of joint ventures involving a foreign partner who is well connected with the government in the host country; local customs regarding gifts, travel, and entertainment for government officials that conflict with U.S. law and practice; and the offer or expectation of investment opportunities or discounts for such officials or their families. Private equity fund investments in foreign portfolio companies may be subject to additional risks such as successor liability or control person liability of parent company executives for violations by a portfolio company.

It was widely reported in 2011 that the SEC sent informal letters of inquiry to certain banks and private equity firms requesting information related to their dealings with sovereign wealth funds.[1] That inquiry was viewed as the beginning of an industry-wide FCPA probe of investment firms similar to investigations initiated in prior years regarding the U.S. pharmaceutical and petroleum industries. At the same time, financial regulators in the United States and abroad increasingly are focusing on efforts to prevent the entanglement of financial services businesses in foreign corruption by strengthening requirements for anti-money laundering due diligence with respect to "senior foreign political figures" (also known as "politically exposed persons"), and emphasizing compliance with such requirements, as a means of controlling the flow of foreign corruption proceeds into legitimate investment vehicles.

Potential Benefits of Effective Policies and Procedures

The outcome of the Peterson case reinforces the value to financial services firms of maintaining strong FCPA compliance programs and implementing effective measures for identifying and addressing irregular employee or counterparty conduct that may signal potential violations, particularly for investment transactions and ventures involving countries with a substantial corruption risk.

[1] Please see Willkie Farr & Gallagher LLP Client Memorandum, "SEC Investigating Financial Industry's Compliance with the Foreign Corrupt Practices Act When Dealing with Sovereign Wealth Funds" (Jan. 20, 2011), available here.

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