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THE US PRIVATE REAL ESTATE FUND COMPLIANCE GUIDE

How to register and maintain an active and effective compliance program

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7 Foreign Corrupt Practices Act

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Introduction

Private real estate advisers that operate in non-US jurisdictions, or interact with non-US governments or third parties that do, are subject to the oversight of the US Department of Justice (DOJ) by way of the Foreign Corrupt Practices Act of 1977 (FCPA). The FCPA, which encompasses all US entities and persons (and many foreign ones) is an anti-corruption measure that imposes not only prohibitions against corruptly offering bribes to obtain or retain business, but also recordkeeping and control obligations on investment funds that require imposing adequate anti-bribery compliance mandates.

The Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank)'s introduction of a new requirement for some advisers to private real estate funds to register with the SEC will subject these advisers to US regulatory enforcement of the FCPA. Even if a private real estate fund adviser is exempt from Dodd-Frank's registration requirement, it may still face new recordkeeping and reporting obligations. This chapter addresses the FCPA, the compliance risks that private real estate funds may face, and the steps that these funds can take to protect themselves from violations of the FCPA.

The FCPA

Private real estate advisers generally are subject to the FCPA in one of two ways: as 'issuers' or as 'domestic concerns.' Issuers are any companies whose securities are registered in the US or that are required to file periodic reports with the SEC. Since the enactment of Dodd-Frank, private real estate advisers are required to register with the SEC and to file periodic reports, the most prominent memorialized on Form ADV. By virtue of this filing obligation, private real estate advisers are required to meet the components of the FCPA as overseen by the DOJ and SEC. Domestic concerns are any individuals who are US citizens, nationals or residents of the US or any business organization that has its principal place of business in the US or which is organized in the US. Other persons who assist in any way in making a corrupt payment while within the territory of the US are also subject to the FCPA. Private real estate advisers may also fall within the scope of the FCPA as a domestic concern.

The FCPA prohibits corruptly giving, promising or offering (or authorizing the giving of) anything of value to a foreign government official, political party or party official with the intent to influence that official in his or her official capacity to secure an improper advantage in order to obtain or retain business. The FPCA also requires companies publicly traded in the US to maintain accurate books and records and to maintain reasonably effective anti-bribery internal controls.

US regulators have interpreted the term 'foreign official' expansively to include any officer or employee of a foreign government or any department, agency or

instrumentality of the government. This includes government-owned or government-controlled businesses and enterprises, even if the government is a minority stockholder. Although the scope of what constitutes a foreign official has only recently been challenged in court (because most companies opt to settle rather than litigate), recent challenges to the government's expansive definition of a foreign official have failed in court. For instance, the court in *US v. Noriega,* No. 2:10-cr-01031-4 (AHM) (CD Cal. 2010), rejected the argument that officers and employees of state-owned enterprises (SOEs) could not qualify as foreign officials. Similar arguments have been made, and rejected, in other cases. Employees of such SOEs can often be overlooked as potential sources of risk, especially in countries where foreign corporations are encouraged to partner with local entities in order to do business in the country.

The FCPA's prohibition against giving 'anything of value' contains no *de minimis* exception – liability exists from the first dollar and is not limited to tangible items of economic value. According to the FCPA, liability can include anything a recipient would find interesting or useful, including gifts, entertainment, internships, loans, consulting fees, meals, professional training or education, or political or charitable contributions. The breadth of this coverage presents a challenge for real estate transactional negotiations. In many countries, the giving of holiday or personal gifts is customary businesses practice and the failure to provide them to potential counterparties can be seen as rude or even offensive.

Indirect corrupt payments, those made by agents or vendors for the benefit of the private real estate fund, are equally prohibited. Companies should ensure that the third parties with which they engage have been properly trained and will not make corrupt payments on their behalf. Typically, this is accomplished through third-party due diligence procedures (see below for third-party due diligence suggestions for private real estate funds). Of course, not all payments are provided 'corruptly.' Corruptly has been interpreted to mean paying to obtain or retain business or secure any improper advantage.

Settlement of FCPA violations can cost companies greatly. The SEC and DOJ have been increasing their enforcement activity; eight out of the top ten historic FCPA-related settlements by total monetary penalty amount were settled in 2010 and 2011. On April 25, 2012, the SEC charged a former executive in Morgan Stanley's real estate investment and fund advisory business, Garth R. Peterson, with violating the FCPA by secretly acquiring millions of dollars' worth of real estate investments both for himself and for an influential former chairman of a Chinese SOE who in turn steered business to Morgan Stanley's funds. Peterson's principal responsibility at Morgan Stanley was to evaluate, negotiate, acquire, manage and sell real estate investments on behalf of Morgan Stanley's advisers and funds. The SEC alleges that Peterson led Morgan Stanley's effort to build a Chinese real estate investment portfolio for its funds by cultivating a relationship with the Chinese official and taking advantage of his ability to steer opportunities to Morgan Stanley and his influence in helping to obtain necessary government approvals. Morgan Stanley conducted an internal investigation to determine the scope of the improper payments and misconduct and disclosed its

investigation in early 2009. Peterson agreed to a settlement with the SEC in which he will be permanently barred from the securities industry, pay more than $250,000 in disgorgement and relinquish his interest in the valuable Shanghai real estate (currently valued at approximately $3.4 million) that he secretly acquired through his misconduct. The DOJ has filed a related criminal case against Peterson, but not Morgan Stanley.

One important enforcement trend is in the area of successor liability. Successor liability can be generated by misconduct that occurred by the target prior to acquisition, or after the acquisition is completed due to deficiencies in the acquired company's control environment. The details of some cases in 2011 underscore the imperative that acquisitive companies conduct thorough pre-acquisition due diligence and have equally robust post-acquisition compliance integration. As significant as these settlements are, they are not large enough to qualify as one of the largest ten historic FCPA-related settlements.

For example, on July 13, 2011, the DOJ and the SEC announced settlements with Armor Holding, Inc., which was acquired by BAE Systems Plc. in 2007, in connection with alleged violations of the FCPA. To settle the SEC charges, Armor agreed to disgorge $1,552,306 in allegedly illicit profits plus $458,438 interest, in addition to a $3.68 million civil penalty. To resolve the DOJ charges, Armor agreed to pay a $10.29 million criminal fine under a non-prosecution agreement.

In another example, on July 27, 2011, after the SEC alleged improper payments made through three acquired foreign subsidiaries, Diageo Plc. agreed to disgorge $11,306,081 in profits, plus $2,067,739 in prejudgment interest in addition to a $3 million civil penalty. According to the SEC, Diageo's 'history of rapid multinational expansion through mergers and acquisitions contributed to defects in its FCPA compliance programs' that allowed the payments to take place.

Risks for private real estate funds

Corruption risk wears no single face. It presents risks in various forms depending on the nature of the business engaged in, the level of involvement of government officials in some aspects of the negotiation, approval or renewal of a business (government officials in many regions expect to be 'fed' corruptly from a deal), and the country and type of business involved. The risk profile of a particular private real estate fund is subject to the same considerations as other private funds, but the risks tend to present themselves in ways that differ from other business ventures. Private real estate funds are unique in that their asset class can include equity and debt investments in real property, their investments typically are held over a longer lifespan than other investments, and their investors tend to tolerate an uncertain and lengthy return on their investments.

Fund investment

Investors in private real estate funds tend to be large institutions and wealthy individuals. Sovereign wealth funds from Asia, Europe and the Middle East have been a growing constituency of investors, so much that US regulatory authorities have

begun to heavily focus on sovereign wealth investment and corruption concerns. The SEC has undertaken a well-publicized broad investigation of non-US government-related investors. In early 2011, the SEC sent letters of inquiry to banks such as Citigroup and private equity firms, including the Blackstone Group, requesting that the firms retain documents and share information about their dealings with sovereign wealth funds.[1]

Because sovereign wealth funds are owned and operated by foreign governments, their directors, officers and employees will likely be considered 'foreign officials' under the FCPA. For example, Goldman Sachs is under investigation based on its alleged agreement to pay a $50 million fee that would have been passed along to a politically connected investment manager. The government's interest in sovereign wealth funds as potential customers of private real estate funds create a heightened risk for these funds when they partner with sovereign wealth funds, either as an investor in a fund or in a private real estate fund's management company.

As the SEC expands its areas of focus for advisers to private real estate funds, they reasonably might include investigations into co-investments by principals of the fund or funds' adviser, as well as undisclosed ownership in the subject property by the adviser or its affiliates. While these risk areas do not directly involve the FCPA, it is advisable for private real estate advisers to pay particular attention to the involvement of government officials when undertaking these deals. The involvement need not be direct – third-party engagement by an adviser to handle its dealings can potentially trigger red flags. Further, risks are created when investments are made in properties or assets located in countries with a high perceived risk of corruption, based on Transparency International's Corruption Perceptions Index. The index is a metric that ranks countries according to their perceived levels of public sector corruption out of 183 countries and generates a score for each country on a scale of 0 (highly corrupt) to 10 (very clean). Doing business in countries with a heightened risk of corruption is cause for heightened scrutiny.

Government and third-party interaction

Because private real estate funds invest in or deal with real property, the third parties it contracts with may involve government contact, thus leading to the risk for corruption. For example, properties must be properly appraised to determine its value. The pressure to receive a favorable valuation can create a risk of corruption, especially if government officials are involved. In many countries, the government may be the seller of certain properties, a scenario which heightens the risk of all transactions surrounding the fund's acquisition of those properties. In addition, investing in or maintaining properties may require obtaining regulatory licenses or government approvals. These interactions are also at risk of corruption. Under the FCPA, a firm can be liable for the improper payments of the third parties it contracts with to handle its dealings, which may involve interactions with foreign officials.

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[1] Searcey, Dionne and Randall Smith, SEC Probes Banks, Buyout Shops Over Dealings with Sovereign Funds, *Wall Street Journal*, January 14, 2011.

Some of these third parties are law firms, accounting firms and other consultants. These third parties often will have their own anti-corruption programs and take care that their own interactions with foreign officials are proper. However, it is incumbent on the fund adviser to ensure that the third parties it contracts with do not make improper payments on its behalf.

Governments can also be business partners when private real estate funds invest in properties or participate in joint venture development projects. Even if the SOE's involvement is minimal, it should not be overlooked as a potential FCPA violation.

Compliance disclosure obligations

When making a property investment, private real estate funds may receive material not otherwise public information, some of which may relate to past or ongoing corruption surrounding the property. The DOJ has stated that it expects companies acquiring targets with foreign operations to include FCPA-specific pre-acquisition due diligence. The DOJ has an opinion review procedure where companies can ask for guidance on due diligence and compliance procedures in the context of merger and acquisition activity.

However, there are drawbacks to this process, including: (i) the DOJ does not have to accept the request and comment; (ii) its advice is publicly disseminated; and (iii) from the nature of the request and disclosed facts making a request can equally alert the regulators and public of the identity of the requester. For example, when Halliburton wanted to buy Expro through a hostile takeover and did not have enough time to do a full corruption due diligence, it asked the DOJ for an advisory opinion on its potential liabilities given the information it uncovered or would eventually learn on Expro. The DOJ responded in Opinion Procedure Release 08-02 (the Halliburton Opinion) that Halliburton would not be held liable on the condition that it perform a variety of actions immediately after closing to prevent and if necessary, remediate any FCPA violations. Because the DOJ's opinion review procedure is public, all the details of Halliburton's request and the DOJ's strongly suggested subsequent steps were revealed and Expro ended up accepting a competitor's bid.[2]

The FCPA does not require affirmative disclosure of corruption a company uncovers through due diligence, but US regulatory agencies have said they will hold companies liable for corruption in the target companies which they acquire. While the Halliburton Opinion has no precedential value and was not binding on any company except for Halliburton, it helps reveal specific actions that the DOJ believes companies should do, both pre- and post-acquisition. The Halliburton Opinion requires the following steps on closing: first, disclose to the DOJ any FCPA, corruption, internal controls or accounting issues discovered pre-acquisition; and second, present a work plan organizing efforts into risk categories with deadlines for reporting on each risk category.

[2] Op. Proc. Rel. 08-02 (June 13, 2008), available at http://www.justice.gov/criminal/fraud/fcpa/opinion/2008/0802.pdf.

The DOJ also recommends that any corruption uncovered during the work plan's internal investigation should also be disclosed and that Halliburton agree to any additional steps the DOJ suggested to complete the due diligence and remediation plan. The Halliburton Opinion includes suggestions to improve the target's anti-corruption program by imposing a code of conduct and any necessary policies and procedures and training all employees on them; have all agents and other third parties sign new contracts with anti-corruption clauses and audit rights; and suspend, terminate or take other appropriate remedial action against any employees involved in corrupt activities.

Suggested practices for private real estate funds

The US Federal Sentencing Guidelines and the DOJ have both created lists of suggested practices that would constitute a robust anti-corruption program for organizations to adopt in order to protect against bribery and corruption risk. These guidelines track closely the standards expected of regulators outside the US (for example, those encouraged by the UK regulators in support of their anti-corruption statute, the UK Bribery Act and the members of OECD). The list is as follows:

- Code of conduct
- Tone at the top
- Anti-corruption policies and procedures
- Use of risk assessment
- Annual review
- Senior management oversight and reporting
- Internal controls
- Training
- Ongoing advice and guidance
- Discipline
- Use of agents and other business partners
- Contractual compliance terms and conditions
- Ongoing assessment

Some risks commonly associated with the discovery of corrupt activities in a company include:

(i) The potential acquisition of an overvalued asset, as the target's financial statements may be inflated by contracts obtained through corrupt practices or other fallout from incorrect books and records due to 'covering up' evidence of bribery (financial risks)
(ii) Investigations and convictions of a company and/or its directors and officials under applicable anti-corruption laws (legal risks)
(iii) Business instability, as a consequence of reputational damage caused by the publicity of alleged misconduct (reputational risks)

As the nature of these risks indicates, their presence reflects not only corruption risk, but also fraud risk generally.

Code of conduct, tone at the top and policies

Registered private real estate advisers are required to adopt a written code of conduct or code of ethics that details a standard of conduct for its employees. This code should include both a policy against corruption and violations of the FCPA, and its commitment to keeping its books and records in order and internal controls in place. In doing so, the company demonstrates its commitment to an ethical business both to the general public and its employees. Setting a strong 'tone from the top' against corruption is recommended by US regulatory authorities as an important component of a company's anti-corruption program. Having appropriate policies in place is important, but they will be less effective without the commitment of senior management. Compliance with the FCPA has traditionally been viewed as the domain of the legal department. However, because improperly recorded books and lack of necessary internal controls can impact other areas of business, it is important that senior management communicates the relevance of compliance with the FCPA to all departments in their daily work to ensure the ongoing success of the business.

Anti-corruption policies and procedures can be stand-alone or be incorporated into existing policies or procedures. The DOJ recommends that at minimum, standards and procedures should include policies governing the following areas: gifts; hospitality, entertainment and expenses; customer travel; political contributions; charitable donations and sponsorships; facilitation payments; and solicitation and extortion. These represent areas of a higher risk of corruption. It is imperative that companies educate their employees on proper business conduct in these areas without resorting to corruption.

For example, while giving and receiving gifts and hospitality is a customary way to strengthen business relationships and can be a legitimate business practice, it can be risky if the gift or invitation of hospitality is so lavish, frequent or without business purpose that it raises an issue of impropriety and even go so far as to be considered an attempt to improperly influence the professional judgment of the recipient. The same can be said for political contributions, charitable donations or sponsorships. It is therefore prudent to construct policies that detail the company's position on these matters and explain in detail how its employees may strengthen business relationships in a proper manner.

A limited exception to the FCPA's prohibition against improper payments involves facilitation payments. Facilitation payments are best defined as a small-scale payment to a public official to expedite or secure the performance of a non-discretionary, routine and legitimate governmental action. One example is a payment to avoid an unreasonable delay in the receipt of a permit or license under circumstances where the requested documents would normally be provided even if no payment was made. This is a very narrow exception to the FCPA and therefore, counsel often recommends that companies ban facilitation payments entirely for two reasons. First, the exception only covers payments made abroad and second, only four other countries have a similar exception in their anti-bribery laws. Surveys[3] indicate that

[3] KPMG, *2008 Anti-Bribery and Anti-Corruption Survey*; see also TRACE International Facilitation Payments Benchmarking Survey.

approximately 80 percent of companies have banned facilitation payments outright. Regardless whether a company chooses to allow or ban facilitation payments, it is an area on which the company should have a policy, including what employees are expected to do should they face a government official requesting a facilitation payment or type of extortion.

Risk assessment

Conducting regular risk assessments is regarded as a recommended practice by US and foreign regulators as a way to mitigate corruption-related risks successfully. According to the Committee of Sponsoring Organizations of the Treadway Commission – a joint initiative of accounting, finance executive and auditor trade organizations to develop frameworks and guidance on enterprise risk management, internal control and fraud deterrence – organizations should establish mechanisms to address risks associated with changes in the 'economic, industry, regulatory and operating conditions' of their businesses. Similarly, both the US Sentencing Guidelines and the US Federal Prosecution Principles (which set parameters on US criminal penalties) identify corruption risk assessment as one of the important factors for determining whether a company has established an effective ethics and compliance program. In particular, the Sentencing Guidelines state that an 'organization shall periodically assess the risk of criminal conduct and shall take appropriate steps to design, implement or modify each' of the elements of an effective compliance program specified in the Guidelines to 'reduce the risk of criminal conduct identified through this process.'

Risk assessments are vital to understand where the most likely areas of risk lie specific to a company's business. As part of a risk assessment, the following elements can be investigated: geographical organization, interactions with various types and levels of government officials, industrial sectors of operation, involvement in joint venture arrangements, importance of licenses and permits in the company's operations, degree of governmental oversight and inspection, and volume and importance of goods and personnel clearing through customs and immigration. While these areas have risk potential, not all will be relevant to every company's operations. Risk assessments should be tailored to the type of investments in which any specific real estate fund engages.

Risk assessments can be used as a 'gap analysis' to determine which potential areas of risk should be addressed, including what policies, procedures or internal controls may be missing or weak. The benefit to conducting risk assessments is that any findings or recommendations are specific to the company's operations. It is also a good opportunity to address concerns that exist on a local level and take into account relevant developments in the field and evolving international and industry standards. Conducting risk assessments on a regular basis can help ensure that the anti-corruption policies and procedures in place are not in name only but rather working pieces of a robust anti-corruption program.

Third-party due diligence

While performing due diligence on agents and other third parties, it is important to include inquiries into the third parties' potential risk areas, those inherent to the industry

like those listed prior, to safeguard against being held liable for their corrupt actions done on one's behalf. Such diligence should be conducted both pre- and post-acquisition, prior to contracting with new agents or third parties, and renewed on a regular basis to ensure that the third parties continue to understand that no corrupt actions will be tolerated.

Companies may also request that their business partners or third parties warrant against corruption, give audit rights, or otherwise certify their commitment to corrupt-free business practices.

Conclusion

Following the enactment of Dodd-Frank, private real estate advisers registered or are registering with the SEC are obligated to ensure that their books and records will be kept in a manner that complies with the FCPA. Ideally, companies will already be in compliance with the basic meaning of the FCPA: avoiding making improper payments to foreign officials and maintaining accurate books and records and internal controls. However, because of the SEC's recent interest in the interaction between advisers and sovereign wealth funds and certain risks inherent in the nature of real estate investing, advisers to private real estate funds are wise to ensure that the funds employ a full suite of anti-corruption recommended practices. □

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