

DOJ/SEC Bring First FCPA Case Involving Private Fund Investment Adviser

On April 25, 2012, the Securities and Exchange Commission (the “SEC”) charged a former Managing Director in Morgan Stanley’s Chinese real estate investment and fund advisory group with violations of the Foreign Corrupt Practices Act (the “FCPA”), under Sections 30A(g) and 13(b)(5) of the Securities Exchange Act of 1934 (the “Exchange Act”). He is also charged with aiding and abetting Morgan Stanley wholly-owned investment advisers in violation of the anti-fraud provisions of the Investment Advisers Act of 1940 (the “Advisers Act”), namely Sections 206(1) and 206(2). On the same day, the executive pleaded guilty to DOJ’s one-count criminal information charging him with conspiring to evade internal accounting controls that Morgan Stanley was required to maintain under the FCPA. This case represents the first FCPA-related charges involving a private fund investment advisor.

The SEC and DOJ allege that Garth R. Peterson, 42, an American citizen living in Singapore, exploited his personal friendship and secret business relationship with a Chinese government official to steer business opportunities to the real estate investment funds managed by his employer, Morgan Stanley, as well as to “secretly acquire” millions of dollars worth of real estate investments for himself and the Chinese official. The Chinese official was the former Chairman of Yongye Enterprise (Group) Co., a Chinese state-owned and state-controlled entity through which Shanghai’s Luwan District managed its own property and facilitated outside investment in the district.

Robert Khuzami, Director of the SEC’s Division of Enforcement, summed up the case with the following statement: “Peterson crossed the line not once, but twice. He secretly bribed a government official to illegally win business for his employer and enriched himself in violation of his fiduciary duty to Morgan Stanley’s clients.”

The SEC and Mr. Peterson have agreed to settle this matter. Although subject to court approval, Mr. Peterson agreed to be permanently barred from the securities industry, pay more than \$250,000 in disgorgement, and relinquish his approximately \$3.4 million interest in valuable real estate that he acquired through his misconduct. With respect to the DOJ charges, Mr. Peterson will appear for criminal sentencing on July 17, 2012, where he faces a maximum five years in prison and a maximum fine of \$250,000 or twice his gross gain from the offense.

The SEC complaint, filed in the Eastern District of New York, contends that from at least 2004 to 2007, Mr. Peterson, whose principal responsibility was to evaluate, negotiate, acquire, manage and sell real estate investments on behalf of Morgan Stanley’s advisers and funds, led Morgan Stanley’s expansion of its Chinese real estate investment portfolio “by cultivating a relationship with the Chinese official to take advantage of his ability to steer opportunities to Morgan Stanley, his familiarity with and influence in helping with governmental approvals, and his real estate investment and management experience generally.” At Mr. Peterson’s encouraging, Morgan Stanley partnered with Yongye, led by the Chinese official, on a number of major Chinese investments. Mr. Peterson openly credited the Chinese official with helping secure important local Chinese approvals in emails to other Morgan Stanley personnel, and in at least one email described Yongye as “our friends who are coming in because WE OWE THEM A FAVOR.” Earlier that week, in response to an email discussing the terms of an investment, he wrote, “Everyone pls keep in mind the big picture here. [Yongye] gave us this deal...So we owe them a favor relating to this deal. ... This should be very easy and friendly.”

During the same period of time, Mr. Peterson and the Chinese official expanded their own personal investment portfolios by secretly acquiring real estate interests from Morgan Stanley funds, and by investing together in

Chinese franchises of U.S. fast food restaurants. Although required by company policy to annually disclose personal business interests, Mr. Peterson failed to disclose any of these business transactions.

In one instance, the SEC contends that Mr. Peterson secretly arranged for Morgan Stanley to pay at least \$1.8 million to himself and the Chinese official disguised as third-party finder's fees. The SEC and DOJ allege in another instance that Mr. Peterson convinced Morgan Stanley, through false representations, to sell its interest in Shanghai real estate to a shell company that he claimed was owned by Yongye. Mr. Peterson failed to mention, however, that the shell company, Asiasphere Holdings Ltd. ("Asiasphere"), was in fact owned by Mr. Peterson, the Chinese official, and an unnamed Canadian attorney. Both during and after the transaction, Mr. Peterson repeatedly misrepresented that Yongye owned the company. Through his dual-sided negotiation of the deal, Mr. Peterson secured Morgan Stanley's approval for a deeply discounted sale price, resulting in an immediate profit of about \$2.5 million for Mr. Peterson and his business partners. After the sale, Mr. Peterson continued to claim that Yongye owned the shell company, while at the same time accepting equity distributions and watching his investment appreciate in value. Mr. Peterson's "self-dealing and misappropriation" breached the fiduciary duties he and Morgan Stanley owed to their clients.¹ Mr. Peterson was terminated in 2008 due to his misconduct.

The SEC charged Mr. Crisp with willful violations of Sections 206(1), 206(2) and 206(4) of the Advisers Act, and Section 10(b) of the Exchange Act and Rule 10(b)-5 thereunder. In the alternative, the SEC charged Mr. Crisp with willfully aiding and abetting and causing Adams Street's violations of Sections 206(1), 206(2) and 206(4) of the Advisers Act, which prohibit fraudulent conduct by an investment adviser. The charges against Mr. Crisp are still pending.

Morgan Stanley Faces No Civil or Criminal Charges

Despite bribes paid with Morgan Stanley funds, Morgan Stanley faces no charges stemming from Mr. Peterson's conduct. Instead, Mr. Peterson has been characterized as a "rogue" employee whose deceptions circumvented his employer's aggressive, carefully thought-out internal controls. Kara Novaco Brockmeyer, Chief of the SEC Enforcement Division's FCPA Unit, described Mr. Peterson as "a rogue employee who took advantage of his firm and its investment advisory clients...while lining his own pockets and those of an influential Chinese official." Similarly, U.S. Attorney Loretta E. Lynch (E.D.N.Y.) stated that Mr. Peterson, "used a web of deceit to thwart Morgan Stanley's efforts to maintain adequate controls designed to prevent corruption."

The SEC and DOJ took pains to describe with detail Morgan Stanley's internal controls and compliance program. Morgan Stanley's controls consisted of:

- 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.
- Frequent training of employees on Morgan Stanley's internal policies, the FCPA, and other anti-corruption laws.

¹ The Peterson case is similar in this respect to the matter the SEC brought last year against Matthew Crisp, a partner of Adams Street Partners, LLC ("Adams Street"), a SEC-registered investment adviser that manages multiple private equity funds. The SEC alleged that Mr. Crisp breached fiduciary duties he and his employer owed to his clients when he formed a private investment vehicle called AV Partners LP with a friend and caused Adams Street to allocate co-investment opportunities to AV Partners without disclosing his ownership interest. Like Mr. Peterson, Mr. Crisp breached fiduciary duties he and his employer owed to his clients through self-dealing and misappropriation of an investment opportunity and related profits.

- 54 trainings between 2002 and 2008 of various groups of Asia-based personnel on anti-corruption policies.
 - Trained Mr. Peterson on the FCPA at least seven times, including a teleconference training conducted by high-ranking personnel.
 - Provided Mr. Peterson at least 35 FCPA-compliance reminders, including FCPA-specific distributions, circulations addressing the FCPA, policies on gift-giving and entertainment, the company's Anti-Bribery Policy, guidance on the engagement of consultants, and other policies addressing high-risk events.
 - Distributed written training materials specifically addressing the FCPA, which Mr. Peterson maintained in his office.
- A requirement that Morgan Stanley's employees annually certify adherence to its Code of Conduct, which addressed specific FCPA risks.
 - A requirement that Morgan Stanley's employees annually disclose their outside business interests.
 - Regular monitoring of transactions; random audits of employees, transactions and business units; and testing for illicit payments.
 - Extensive due diligence on all new business partners and stringent controls on payments made to business partners.

Morgan Stanley's persistent and extensive internal controls appear to have played a role in both the SEC and DOJ's decisions not to charge the company, as did the fact that the company self-reported the issues and terminated Mr. Peterson. In its press release, the DOJ stated that it declined to bring any enforcement action against Morgan Stanley related to Mr. Peterson's conduct "[a]fter considering all the available facts and circumstances, including that Morgan Stanley constructed and maintained a system of internal controls, which provided reasonable assurances that its employees were not bribing government officials." The DOJ's explanation alludes to the provisions of the 2011 Federal Sentencing Guidelines, Section 8B2.1. In a document entitled, *An Overview of the Organizational Guidelines*, Paula Desio, Deputy General Counsel, United States Sentencing Commission, outlines six key criteria for establishing an "Effective Compliance and Ethics Program." They include:

- Oversight by high-level personnel
- Due care in delegating substantial discretionary authority
- Effective communication to all levels of employees
- Reasonable steps to achieve compliance, which include systems for monitoring, auditing, and reporting suspected wrongdoing without fear of reprisal
- Consistent enforcement of compliance standards including disciplinary mechanisms
- Reasonable steps to respond to and prevent further similar offenses upon detection of a violation

The importance of adequate procedures on liability under the UK Bribery Act, which took effect on July 1, 2011, should also be noted. The broader and stricter UK Act allows companies to be held strictly liable for failing to prevent bribery committed on its behalf. The only defense is to demonstrate that the company had "adequate procedures" in place to prevent such bribery.

The Morgan Stanley case reemphasizes to investment firms the importance of establishing adequate and effective FCPA and anti-corruption internal controls in protecting both the entity and individual personnel from such enforcement.

Contact Ropes & Gray

Ropes & Gray regularly advises clients on FCPA and anti-corruption compliance and potential enforcement actions. If you have any questions about the FCPA or its effect on your business activities, please do not hesitate to contact your regular Ropes & Gray contact.