

E-ALERT | Anti-Corruption

April 2012

FORMER MORGAN STANLEY MANAGING DIRECTOR PLEADS GUILTY TO EVADING INTERNAL CONTROLS RELATED TO CORRUPT REAL ESTATE TRANSACTIONS WITH CHINESE SOE OFFICIAL Morgan Stanley Not Charged Due to Robust Compliance Program

On April 25, 2012, Garth Peterson, a former managing director of Morgan Stanley, [pleaded guilty](#) to a one-count [criminal information](#) filed by the US Department of Justice (“DOJ”) charging him with conspiring to evade the internal accounting controls that his previous employer, Morgan Stanley, was required to maintain under the US Foreign Corrupt Practices Act (“FCPA”). On the same day, the US Securities and Exchange Commission (“SEC”) filed a complaint (the “[SEC Complaint](#)”) charging Peterson with violating the anti-bribery and internal controls provisions of the FCPA and with aiding and abetting violations of the anti-fraud provisions of the Investment Advisors Act of 1940.

Peterson, a former managing director of Morgan Stanley’s real estate business in Shanghai, misrepresented to Morgan Stanley a number of transactions aimed at self-enrichment and towards promoting his relations with an unnamed Chinese official in charge of local real estate transactions.

At the same time, DOJ and SEC announced that they were declining to prosecute Morgan Stanley, in part because the company had “constructed and maintained a system of internal controls, which provided reasonable assurances that its employees were not bribing government officials.”

Alleged Conduct

Peterson began his career with Morgan Stanley in Hong Kong in 2002. In 2006, he was made head of the newly opened Shanghai office of Morgan Stanley’s wholly-owned global real estate business, where he became Managing Director in 2007. Peterson was terminated in 2008 for the alleged conduct described below.

The SEC Complaint centers around the relationship between Peterson and an unnamed Chinese official who served as chairman of Yongye Development Company (“Yongye”), the real estate development arm of the Shanghai Luwan District government. According to the SEC Complaint, Yongye’s business was to take small shares in real estate joint ventures, including with Morgan Stanley, in exchange for helping its joint venture obtain the proper licensing from the local government. As chairman, the Chinese official exercised control over Yongye and had the authority to make investment decisions on its behalf.

The SEC Complaint alleges that Peterson led Morgan Stanley's effort to build a Chinese real estate investment portfolio for its real estate funds by cultivating a relationship with the Chinese official to take advantage of the official's ability to steer investments to Morgan Stanley, his government connections, and his general real estate investment and management experience.

In one of several incidents of bribery and self-dealing described in the SEC Complaint, a Morgan Stanley fund reportedly sought to purchase an apartment building in the Luwan District of Shanghai. As one of the sellers and as the project manager for the selling consortium, Yongye's approval was required before the sale could take place. Peterson, the Chinese official, and an unnamed Canadian attorney sought to enrich themselves by forming a British Virgin Islands entity called Asiasphere Holdings Ltd. ("Asiasphere") to purchase an ownership stake in the apartment following its purchase by the Morgan Stanley fund. To ensure that Morgan Stanley sold a stake back to Asiasphere, Peterson told his co-workers involved in the sale that the Chinese official, in his capacity as chairman of Yongye, had convinced the selling consortium to sell the project to Morgan Stanley at a price lower than a competing offer and that Morgan Stanley "owed him a favor" (e.g., the sale of a small stake in the apartment back to Yongye in appreciation for the lowered price). During the negotiations, the three alleged conspirators misrepresented to Morgan Stanley, on numerous occasions, that Asiasphere was a Yongye subsidiary rather than a company owned and controlled by the trio individually.

Through five separate shareholder distributions from 2006 to 2008, Peterson reportedly pocketed \$860,000 from his ownership of Asiasphere. In addition, Peterson had negotiated through Morgan Stanley to allow Asiasphere to purchase its stake at the original 2004 price, even though by 2006, the time of the purchase, the value of shares had risen from \$3 million to nearly \$6 million.

In another incident described in the SEC Complaint, Peterson reportedly invited the Chinese official to subscribe at discounted rates in five of the projects then in negotiations between Morgan Stanley and Yongye. Under an arrangement called a "3-2-1 deal," Peterson would cause Morgan Stanley to sell the Chinese official a 3% interest in each deal he brought to Morgan Stanley for the cost of only 2%, with the 1% discount being provided to the Chinese official as a "finder's fee." When a company controller discovered the discounted rate, Morgan Stanley instructed Peterson to abandon the deal with the Chinese official. Despite this, Peterson caused the Morgan Stanley fund involved with the project to pay an unidentified Shanghai investor a \$2.2 million "finder's fee." The Shanghai investor transferred \$1.6 million of this fee to Peterson as consideration for future Morgan Stanley business. Peterson then gave \$700,000 of this amount to the Chinese official and kept the rest himself.

During this period, Morgan Stanley maintained a system of internal control policies designed to ensure accountability for its assets and to prevent employees from offering, promising, or paying anything of value to foreign government officials. Peterson was trained on these FCPA policies seven times between 2002 and 2008 and had been reminded to comply with FCPA at least 35 times. Despite this, Peterson reportedly circumvented the company's

internal controls numerous times to ensure his personal enrichment avoided company detection.

Consequences and Implications

At sentencing on October 17, 2012, Peterson faces a maximum penalty of five years in prison and a maximum fine of \$250,000 or twice his gross gain for the offense. In a negotiated settlement with the SEC, Petersen has also agreed to pay \$250,000 in disgorgement and to forfeit Shanghai real estate worth \$3.4 million.

Notably, Morgan Stanley was not charged with any FCPA violations, and the DOJ and SEC, in an apparent first, publicly announced that fact.¹ Both the DOJ and SEC emphasized that Peterson evaded Morgan Stanley's internal controls, describing Peterson as a "rogue employee" who received repeated FCPA trainings and reminders but nevertheless acted improperly.

For companies, this enforcement action suggests the following implications:

- *The importance of a robust system of internal controls.* In explaining its decision not to bring an enforcement action against Morgan Stanley, DOJ specifically cited the company's system of internal controls that "provided reasonable assurances that its employees are not bribing government officials." The DOJ information (paragraphs 13-23) noted that Morgan Stanley's compliance program included the following elements:
 - frequent anti-corruption training, including live presentations, web-based training, and additional FCPA reminders;
 - a payment-approval process to prevent improper payments;
 - numerous compliance officers, including dedicated anti-corruption specialists, that evaluated the retention of third parties, worked with outside counsel to conduct due diligence, conducted random audits of employee transactions in high-risk areas, and aggregated and evaluated expense reports to detect improper payments;
 - a direct reporting line from the compliance department to the Board of Directors, Chief Legal Officer, and Chief Executive Officer;
 - a compliance hotline staffed 24 hours a day that accepted calls in every major language, including Chinese;

¹ In other cases, companies themselves disclosed in securities filings that DOJ and/or SEC had declined to pursue an enforcement action.

- annual employee certifications of adherence to Morgan Stanley's Code of Conduct, which included a section on addressing corruption risks;
 - ongoing internal evaluation and improvement of policies; and
 - an annual review of each of its anti-corruption policies with outside counsel.
- *Care must be taken when dealing with real estate issues in China.* While this is the first FCPA enforcement action in the real estate sector in China, the real estate / land transfer business in China is widely regarded as carrying significant corruption risks. The Chinese government has identified granting of land-use rights and trading in property rights as two of the top six areas for domestic anti-bribery enforcement.²

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If you have any questions concerning the material discussed in this client alert, please contact the following Beijing-based members of our [Global Anti-Corruption practice group](#):

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² *White Paper: China's Efforts to Combat Corruption and Build a Clean Government*, December 2010, section 6.