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Hedging the risk of foreign bribery and corruption

by Andrew Rutherford

Managers of Canadian hedge funds and private equity vehicles need to consider foreign bribery and corruption issues so they can reduce the risk of violating laws concerning the corruption of foreign public officials.

The focus on domestic and international anti-bribery and corruption laws has increased substantially over the last decade. Significant developments include various enforcement actions by the United States Department of Justice ("DOJ") and the Securities and Exchange Commission ("SEC") concerning the Foreign Corrupt Practices Act ("FCPA") and the introduction of the far reaching UK Bribery Act 2010. Also getting attention is the relevant Canadian legislation, the Corruption of Foreign Public Officials Act ("CFPOA") and its assigned resources and recent amendments.

Certain industries are inherently more susceptible to bribery and corruption related risk, mainly those involving high value contracts with government departments/state owned enterprises (e.g. public infrastructure projects and healthcare/pharmaceuticals) and other highly regulated industries with frequent government touch points; however, this does not mean that all other industries are immune to bribery and corruption risks. Investment management firms have not historically been targeted for bribery and corruption enforcement, but recent enforcements of the FCPA by U.S. regulators suggest this is beginning to change. This means regulators in other jurisdictions are likely to follow suit. Investment funds with exposure in foreign jurisdictions need to be aware of the practical issues concerning bribery and corruption risk, which if ignored, may result in significant financial and reputational damage to funds and their stakeholders.

This article examines why managers of Canadian hedge funds and private equity vehicles need to consider foreign bribery and corruption issues. What can these managers, and the companies they are invested in, do to reduce the risk of violating laws concerning the corruption of foreign public officials? It will provide an overview of relevant legislation including recent enforcement, followed by a summary of risk factors affecting the industry and measures that can be employed by managers to mitigate such risk factors.

Anti-bribery and corruption legislation

CFPOA

Like the FCPA (discussed below), the CFPOA, passed in 1999 includes Anti-Bribery and Books and Records provisions, but unlike its American counterpart the legislation is strictly criminal without any administrative remedies. Up until recent amendments, the CFPOA applied only a territory-based principal where the alleged offences may have occurred outside of Canada. This meant that a "real and substantial" link to Canada must have existed in order for the actions to be prosecuted under the law. In other words, a significant portion of the activities constituting an offence must have been committed or must have taken place in Canada, or have had a real impact on Canadians (which made enforcement of the law in cases with an extra-territorial aspect difficult). Amendments to the legislation made in June 2013 inter alia allow the prosecution of bribery offences committed outside of Canada if the individual is a Canadian citizen, a permanent resident, or an entity incorporated or formed under the laws of Canada or one of the provinces which includes foreign domiciled subsidiaries of Canadian corporations.[1]

The June 2013 amendments will also ultimately result in the elimination of the facilitation payments (i. e. smaller payments to facilitate routine government transactions such as permits or paperwork) exception although no date has been set for the enforcement of this provision.

[1] http://opencanada.org/features/the-think-tank/comments/busting-bribery/

Enforcement of the CFPOA has also increased in recent years. In 2007, the RCMP established a dedicated International Anti-Corruption Unit and according to a recent report had approximately 35 ongoing investigations.[2] In 2011, Niko Resources plead guilty to one charge of bribing a foreign official contrary to the CFPOA and was assessed fines of approximately CDN$9. 5 million in addition to undergoing a 3-year court supervised probation period.[3] In 2013, Griffiths Energy International ("GEI") pled guilty to violating the CFPOA as a result of a "consulting" arrangement it had entered into with the wife of Chad's ambassador to Canada, related to the company's contracts with the government of Chad allowing the company to drill for oil in that country. GEI was assessed a CDN$10.4 million fine by an Alberta judge.[4] Finally, in April 2013 a Canadian judge found Nazir Karigar, an Indian-Canadian businessman, guilty of conspiring to bribe high ranking officials of Air India in exchange for a contract with an Ottawa-based facial recognition software company. Under this ruling, the Air India officials were considered to be "foreign public officials" as defined in the legislation. This case was unique in that no evidence was discovered that the officials in question ever accepted any bribes. The Court cited sufficient evidence existed in the form of emails and a spreadsheet created to break down how the bribes would be dispersed in order to find Mr. Karigar guilty of violating the CFPOA.[5]

FCPA

Despite its early lack of enforcement, the Foreign Corrupt Practices Act ("FCPA"), enacted by the United States Congress in 1977, has become the standard anti-bribery and corruption legislation for companies conducting global business.

The FCPA includes two key provisions – The "Anti-Bribery Provision" criminalizes the bribery of foreign officials if the intent of the bribe is to influence an official decision in order to obtain a business advantage, while the "Books and Records Provision" requires companies who file reports with the SEC to meet certain standards regarding their accounting practices, books and records, and internal controls. The FCPA applies to U.S. persons or companies including companies with shares listed on a U.S. stock exchange. The definition of "foreign official" is broad under the FCPA and can include employees of state-owned enterprises.[6]

Rarely enforced until the mid-2000s, the U.S. has been increasingly aggressive in its enforcement of the FCPA in recent years. Notable recent enforcement actions include:[7]

- Alcoa (2014) – Alcoa agreed to pay U.S. $384 million to settle SEC charges that its subsidiaries repeatedly paid bribes to government officials in Bahrain to maintain a key source of business, along with a parallel criminal case.
- Total S.A. (2013) – Total agreed to pay U.S. $398 million to settle SEC charges that it paid bribes to intermediaries of an Iranian government official in order to obtain valuable contracts to develop oil and gas fields.
- Former Morgan Stanley executive (2012) – The former employee agreed to a settlement whereby he is permanently barred from the securities industry, required to pay a U.S. $250,000 disgorgement fine, and forced to relinquish his $3.4 million interest in Shanghai real estate. The executive was charged with secretly acquiring millions of dollars' worth of real estate investments for himself and an influential Chinese official, who in turn steered business to Morgan Stanley's funds.
- Siemens AG (2008) – Siemens AG agreed to pay combined penalties to the SEC and the DOJ of $800 million to settle charges that it engaged in a systematic practice of paying bribes to foreign government officials to obtain business.

UK Bribery Act

In 2010, the UK Bribery Act 2010 ("UKBA") came into effect in the United Kingdom and is widely considered to be more encompassing than the FCPA, although time will tell whether enforcement levels will rival the U.S. legislation. Under the UKBA, the Anti-Bribery provisions are not only applicable to foreign public officials but also private persons and companies carrying on business in the UK. Also, the UKBA does not allow any exceptions for facilitation payments, asserting that such payments "are a type of bribe and should be seen as such[8] as noted above, such payments are currently allowed under certain conditions in the FCPA and the CFPOA, notwithstanding the recent amendments to the CFPOA calling for the elimination of the facilitation payments exception.

Why investment funds and their managers should care about foreign bribery and corruption

The investment management industry is an increasingly competitive environment, causing managers to scour global markets in search of investment opportunities as well as investor capital. In many cases managers are turning to developing economies and emerging markets where the business environment may present elevated risks of corruption. For example, Brazil, Russia, India, and China, commonly referred to

[2] Canada's "Follow-up to the Phase 3 Report & Recommendations (May 2013)" report to the Organisation for Economic Co-operation and Development ("OECD") on Canada's implementation of the OECD Convention on Combating Bribery of Foreign Public Officials in International Business Transactions and the 2009 Recommendation of the Council for Further Combating Bribery of Foreign Public Officials in International Business Transactions: http://www.oecd.org/daf/anti-bribery/CanadaP3writtenfollowupreportEN.pdf

[3] http://www.mondaq.com/canada/x/137024/International+Trade/Canadian+Oil+Gas+Company+Fined+95+Million+For+Bribery+Of+Foreign+Offici al

[4] http://www.canadianbusiness.com/companies-and-industries/the-crackdown/

[5] http://www.theglobeandmail.com/news/national/executive-convicted-in-indian-bribery-conspiracy/article13804839/#dashboard/follows/

[6] A Resource Guide to the U. S. Foreign Corrupt Practices Act, pages 19-20

[7] http://www.sec.gov/spotlight/fcpa/fcpa-cases.shtml

[8] http://www.sfo.gov.uk/bribery--corruption/the-bribery-act/facilitation-payments.aspx

as the "BRIC" emerging market countries, all received scores of less than 50 on Transparency International's Corruption Perceptions Index 2013 where a score of 0 is considered highly corrupt and 100 is very clean.[9] According to a recent report from the United Nations Conference on Trade and Development ("UNCTAD"), in 2013 global foreign direct investment ("FDI") inflows rose by 11% to an estimated U.S. $1.46 trillion in 2013 while FDI flows to developing economies reached a new high of U.S. $759 billion, accounting for 52% of all global FDI inflows in 2013. UNCTAD forecasts that total global FDI flows will rise to U.S. $1.8 trillion by 2015.[10]

In addition to the CFPOA, Canadian based investment funds may be subject to the FCPA and UK Bribery Act depending on the extent of their nexus to the U.S. and UK. Such legislation carries potentially significant fines (not to mention criminal penalties) that warrant consideration when analyzing investment risk in foreign markets. In particular, corruption risk is elevated when acquiring a controlling interest in a company with foreign operations as the legislation carries successor liability meaning that new owners are responsible for past violations of companies. It is therefore essential that an assessment of corruption risk be built in to the due diligence program prior to purchase. The key components of a bribery and corruption risk assessment are discussed later in this article. Managers and those charged with fund governance should also be aware of the following risk factors:

- Risk is elevated when it comes to acquiring a controlling interest in a business operating in foreign jurisdictions as laws often carry successor liability. This means that new owners can be responsible for past violations of companies.
- Funds and private equity vehicles often rely on the services of third party intermediaries and agents to identify and facilitate investment opportunities in foreign markets. For example, funds may hire local consultants to establish connections with foreign governments, such as the facilitation of an introduction with persons responsible for directing investments of sovereign wealth funds or state controlled entities. The definition of foreign public official under the CFPOA is broad and can include executives of state controlled entities (see Nazir Karigar example above). Funds and/or their managers may be liable for the actions of these parties even if they do not have direct knowledge of the illicit actions.
- Sovereign wealth funds – Representing some of the world's largest investors, sovereign wealth funds represent a unique risk to fund managers. With many sovereign wealth funds now turning to fund managers to manage their worldwide assets the competition to secure these assets is growing. Managers would be prudent to proceed with caution concerning their interactions with those responsible for directing investment on behalf of foreign governments given that these individuals may meet the definition of foreign public officials under relevant anti-corruption legislation. There has also been recent indication by U.S. authorities that enforcement efforts will increasingly target the financial services industry. In late 2010 the SEC announced that "industry wide sweeps" would be carried out by its FCPA unit and that "no industry is immune from investigation[11]. In 2011 there were media reports concerning investigations into hedge fund dealings with sovereign wealth funds.
- Hiring practices – A New York Times article in December 2013 revealed the existence of a dedicated program at a well-known investment bank to hire the children of China's ruling elite in order to secure business opportunities with state-controlled entities and that the program was at the center of an ongoing federal bribery investigation by U.S. authorities[12].

What funds/managers need to do to mitigate corruption risk

Pre- and post-acquisition due diligence

For investment funds considering acquiring interest in an entity with operations in a foreign jurisdiction with elevated corruption risk[13] procedures designed to assess bribery and corruption risks should be built into existing due diligence programs. These procedures should include at a minimum:[14]

- The performance of a top-down risk assessment that includes:
  - Examining all licensing, permit, customer, joint venture, and other partnering arrangements with foreign government-related people or entities
  - Identifying the risk of corruption in the target company's countries of origin and operation
  - Investigating reliance on third-party agents with government touch points, and checking due diligence files related to hiring and pairing of agents, and
  - An analysis of industry risk, as certain industries are more susceptible to bribery and corruption, including oil and energy, manufacturing and transformation of goods, pharmaceutical and health care, and public infrastructure projects. Such elevated risk should be evaluated when considering investing in these industries.
- Ascertaining whether the target company has an anti-corruption compliance program in place and assessing the comprehensive and effectiveness of the program;
- Conducting transaction testing to identify potential red-flag issues, such as excessive commissions or discounts to third parties; contracts that include vaguely – described services; invoice descriptions that don't match services rendered; excessive balances in "miscellaneous" expense accounts; transactions with parties closely associated with foreign officials, and; payments to shell companies or offshore bank accounts.

[9] http://www.transparency.org/cpi2013/results
[10] United Nations-UNCTAD-"Global Investment Trends Monitor" No.15-28 January 2014

[11] http://www.sec.gov/news/press/2010/2010-214.htm
[12] http://dealbook.nytimes.com/2013/12/07/bank-tabulated-business-linked-to-china-hiring/?_php=true&_type=blogs&_r=0
[13] Refer to Transparency International's Corruption Perception Index 2013 to see the perceived level of corruption for 177 countries. A score of 0 suggests the country is highly corrupt and a score of 100 indicates the country is very clean.
[14] Investment management anti – fraud and compliance programs – Are you read if the government launches an investigation? Deloitte (2008)

The outcome of the corruption due diligence process may impact the transaction purchase price given the level of associated corruption risk or may warrant reconsideration of the investment altogether.

Internal programs

To mitigate internal corruption risk, funds and their managers should ensure they have documented and implemented anti-corruption compliance programs. An effective compliance program should include:

- A risk-based approach designed to meet the stated risk objectives of the organization
- Policies and guidelines
- Codes of Conduct
- Employee training and certification
- Whistleblower programs
- Risk assessments (to be conducted on site and on a regular basis)
- Periodic review and testing of the program's effectiveness

To mitigate third party risk, fund managers should:

- Ensure a program exists to evaluate third parties for corruption risk prior to establishing a business relationship. The assigned level of risk should be reevaluated on a continuing basis.
- Incorporate warranties and representations concerning compliance with anti-corruption legislation into business partner contracts.
- Ensure business partners receive training on relevant legislation, as well as have them provide an annual certification attesting to their compliance with same.

Policies and procedures

As part of the overall anti-corruption compliance program, fund managers should also maintain specific policies concerning travel and entertainment expenses associated with foreign public officials, which would include any such representatives of sovereign wealth funds. An example of this is maintaining a registry of gifts for employees interacting with foreign public officials. Finally, investment firms need to ensure their hiring practices are adequately scrutinized for potential violations of applicable anti-corruption legislation. The new employee recruitment/hiring process should be fully transparent and documented, especially concerning the hiring of a relative of a foreign public official. In the event necessary, firms will need adequate documentation to justify to authorities that the hiring was based on merit rather than an expectation of retaining foreign government business.

Now that you know

The recent step up in global enforcement actions and comments from US regulatory authorities are evidence that noncompliance with applicable anti-corruption legislation is a real and present risk for the investment fund industry. With ever-increasing competition in the industry, funds will continue to look for opportunities beyond their own borders. If they have not already, funds and their managers should appoint a dedicated team or person responsible for the anti-corruption compliance program. An effective risk-based program requires the support of the organizational leadership and should be evaluated, tested, and adjusted on an ongoing basis according to the corruption risk factors facing the organization.

For more information contact:

Peter Dent
Partner, Deloitte Forensic
416-601-6692
pdent@deloitte.ca

Lynda Boisvert
Partner, Deloitte Forensic
514-393-5971
aboisvert@deloitte.ca

Andrew Rutherford
Senior Manager, Deloitte Forensic
514-393-7137
anrutherford@deloitte.ca

www.deloitte.ca