

FCPA Compliance: Third-Party Due Diligence

Minimizing Corruption Risks When Using Foreign Agents, Distributors and Other Intermediaries

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FCPA Compliance: Third Party Due Diligence

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January 31, 2012

**Mitigation of Corruption Risks
when using Third Parties Abroad**

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Overview: Foreign Corrupt Practices Act

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- Enacted in 1977 for the purpose of making it unlawful for certain classes of persons and entities to make payments to foreign government officials to assist in obtaining or retaining business
- As a result of U.S. Securities and Exchange Commission investigations that found over 400 U.S. companies had made questionable or illegal payments in excess of \$300 million to foreign government officials, politicians, and political parties
- Accounting Provisions: The FCPA also requires publicly traded U.S. companies to maintain accurate “books and records” and reasonably effective internal controls

Overview: Foreign Corrupt Practices Act

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Anti-bribery provision

Prohibits U.S. companies, issuers, and persons in the United States or agent acting on their behalf from giving (or offering, promising, 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 or to secure an improper business advantage

Books and Records/Internal Controls provisions

Require issuers (U.S. and foreign companies with securities registered in the U.S. and required to file reports with the SEC) to maintain accurate “books and records” and effective internal controls (including all owned or controlled foreign subsidiaries)

Antibribery Provision

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Elements of a violation:

- Offer, payment, promise or authorization
- Anything of value
- To foreign official (*directly or indirectly*)
- With corrupt intent
 - Influencing any official act or decision of the foreign official
 - Inducing official to do or omit to do any act in violation of lawful duty
 - To secure any improper advantage
- For any business purpose
 - Obtaining/retaining business or directing business to any person
 - **Any improper business advantage** for any person will likely suffice (e.g., avoiding Customs duties, seeking confidential bidding information)



Anything of Value

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Any tangible or *intangible* benefit

- Cash, cash equivalents
 - Travel, lodging, meals, entertainment
 - Guarantees, discounts, free products or services
 - Offers of employment or other benefits to the recipient or a family member
 - Charitable contributions (even to a legitimate charity)
 - Gifts of any kind, personal favors
- No statutory *de minimis* for **corrupt payments or gifts**



Foreign Officials

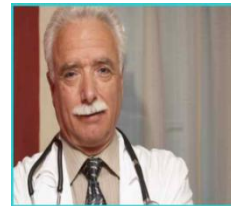
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The FCPA prohibits corrupt payments to “foreign officials”

- Any officer or employee of government department, agency or instrumentality or any public international organization (e.g., UN, European Commission, IMF or International Red Cross)
- Any political party or party official, or candidate for political office
- Any person acting in the capacity of a government official or on behalf of any of the foregoing

Broadly construed by the DoJ/SEC

- Any officer or employee (including low-level employees and officials) of government-owned or government-controlled businesses and enterprises.
- Doctors at government-owned hospitals



Liability for Third Party Payments

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U.S. Company/Issuer violates FCPA if:

- Authorizes/makes payment to a third party
- With “*knowledge*” that third party will make a corrupt payment
 - “*Substantially certain*” corrupt payment will be made
 - Aware of “*high probability*” corrupt payment will be made
- “Reckless disregard”
- “Conscious avoidance”



Risks of “Conscious Avoidance”

Frederic Bourke’s 2009 conviction for conspiring to violate the FCPA

- Investment in failed plan to privatize petroleum industry in Azerbaijan
- Invested in entity he had reason to know intended to bribe Azerbaijan officials
 - Aware of pervasive corruption in Azerbaijan
 - Knew reputation of business partner as the “Pirate of Prague” known for “shady dealings”
 - Created the American advisory companies to shield himself and other American investors from potential liability from payments made in violation of FCPA
- Sentence: 366 days in jail and \$1 million fine
- Judge: “Knowledge may be proven [if] the person suspects the fact, realized its high probability, but refrained from obtaining the final confirmation because he wanted to be able to deny knowledge”

Third Parties

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- Local agents/sales representatives
- Consultants/advisors
- Brokers
- Subsidiaries or JV partners
- Distributors
- Freight forwarders
- Other intermediaries



Some Red Flags for Third Parties

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- Abnormal cash payments
- Large commissions
- Requests that commission be split or paid to another party
- Payments to offshore accounts or in different currencies
- Recommended by government officials
- Claims of special relationships with government officials
- Personal or professional ties to the government
- Employs retired officials from relevant government entity
- Employs unnamed consultants or advisors or insists on using a particular contractor
- Required payment in advance of contract award
- Pressure for payments to be made ahead of schedule
- Abnormal access to “inside” information
- Private meetings with government officials
- Lack of relevant expertise expected in business area – no track record
- Lack of adequate resources to do work – one or two person business
- Limited or no work product
- Refusal to agree to audit rights
- Invoices being agreed in excess of contract without reasonable cause
- Reputation for shady dealings



Agents

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Many prosecutions for making improper payments through agents

- **UTStarcom, Inc. (2009):** U.S. telecom company allegedly paid \$1.5m to the company's agent in Mongolia, claiming that it was for a "*license fee*." The fee was only \$50k. Balance was used to make improper payments to a government official.
- **United Industrial Corp. (2009):** U.S. company alleged to have made payments through a subsidiary to an agent (*retired Egyptian Air Force general*) with *conscious disregard* of the high probability the agent would pass part of those payments to EAF officials to influence award of a contract pertaining to a military aircraft depot.
- **Paradigm BV (2007):** Dutch company admitted using an agent in China to pay "commissions" to employees of a subsidiary of the China National Offshore Oil company related to the sale of company software to the subsidiary retained and paid employees of state-owned entities and Chinese national oil companies as internal consultants used to evaluate the company's software and recommend it to their employers' procurement departments

Subsidiaries

- **Schnitzer Steel Ind. Inc. (2006):** A provision in the DPA involving bribes paid by subsidiaries and employees to obtain business states: “Schnitzer Steel accepts and acknowledges that it is responsible for the acts of . . . its wholly owned subsidiary”
- **Diagnostic Products Corp (2005):** DOJ claimed DPC’s Chinese sub acted as DPC's “agent” and violated the FCPA by paying “commissions” to officials (i.e., physicians and laboratory personnel) in government-owned hospitals in China.
- **Oscar Meza (former Director of Asia-Pacific Sales for Faro Technologies, Inc.) (2009):** Allegedly agreed to China Country manger request to do business “the Chinese way” and authorized subsidiary of Faro to pay “referral fees” to employees of Chinese state-owned companies to obtain contracts and that account entries be altered; Company used an intermediary to make these improper payments to “avoid exposure”

Consultants

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- **Paradigm BV (2007):**

Dutch company made a payment to a British West Indies company **recommended** as a consultant **by a Kazakhstan official** to secure a bid for geological software; Paradigm appears to have received no services from the company

Retained and **paid employees of state-owned entities** and Chinese national oil companies as internal **consultants** used to evaluate the company's software and recommend it to their employers' procurement departments

- **Alcatel-Lucent SA (2010):** French issuer's senior executives approved retention and payment of millions of dollars to consultants with **no relevant experience** or in other cases despite obvious indications that the consultants were performing **little or no legitimate work**

ITAR Brokers /Advisors / Consultants

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- BAE plc (UK/issuer)
- Fined \$400m by DOJ and \$79m by DDTC
 - DOJ: False statements regarding FCPA compliance and failure to report commissions as require by ITAR Part 130
 - DDTC: Violations of brokering rules and Part 130: designed to detect improper payments
- Allegedly paid “marketing advisors” through offshore shell companies beneficially owned by BAE, encouraged “marketing advisors” to establish offshore shell companies to receive payments from BAE while disguising the origins and recipients of these payments
- Allegedly established a British Virgin Islands company to conceal marketing advisor relationships, including identity and amount of payment; to create obstacles for investigating authorities to penetrate the arrangements; to circumvent laws in countries that did not allow such relationships; and assist advisors avoid tax liability for payments

Distributors

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- **Fiat S.p.A. (2008):** Fiat (Italian issuer) subs offered a 20% discount to distributors knowing they would pass 10% to the former Iraqi Government
- **AGA Medical Corp. (2008):** U.S. company's distributor in China made improper payments to physicians employed by government-owned hospitals in exchange for purchases of company products. Company employees approved the payment of "discounts" and "commissions" to these doctors. Company employees authorized the Chinese distributor to make payments to government officials to ensure approval of patents
- **InVision Technologies Inc. (2004):** U.S. company's executives were allegedly aware of a high probability that the distributor intended to fund any such gifts or offers out of the difference between the price the distributor paid to acquire the machines and the price for which the distributor was able to resell them

Freight Forwarders/Logistics Companies

- **Panalpina World Transport (2010):** Swiss company bribed numerous foreign government officials on behalf of customers to circumvent local customs processes in various countries. PWT, its U.S. subsidiary and a number of its customers were fined criminally
- **Min Model:** James Min, Vice President, Int'l Trade Affairs & Compliance at DHL developed a model: How often the Customs Broker/Express Delivery Service varies above the average for customs clearance times. If the percentage is high most of the time, this could be a Red Flag that bribery or corruption is involved

Contact Information

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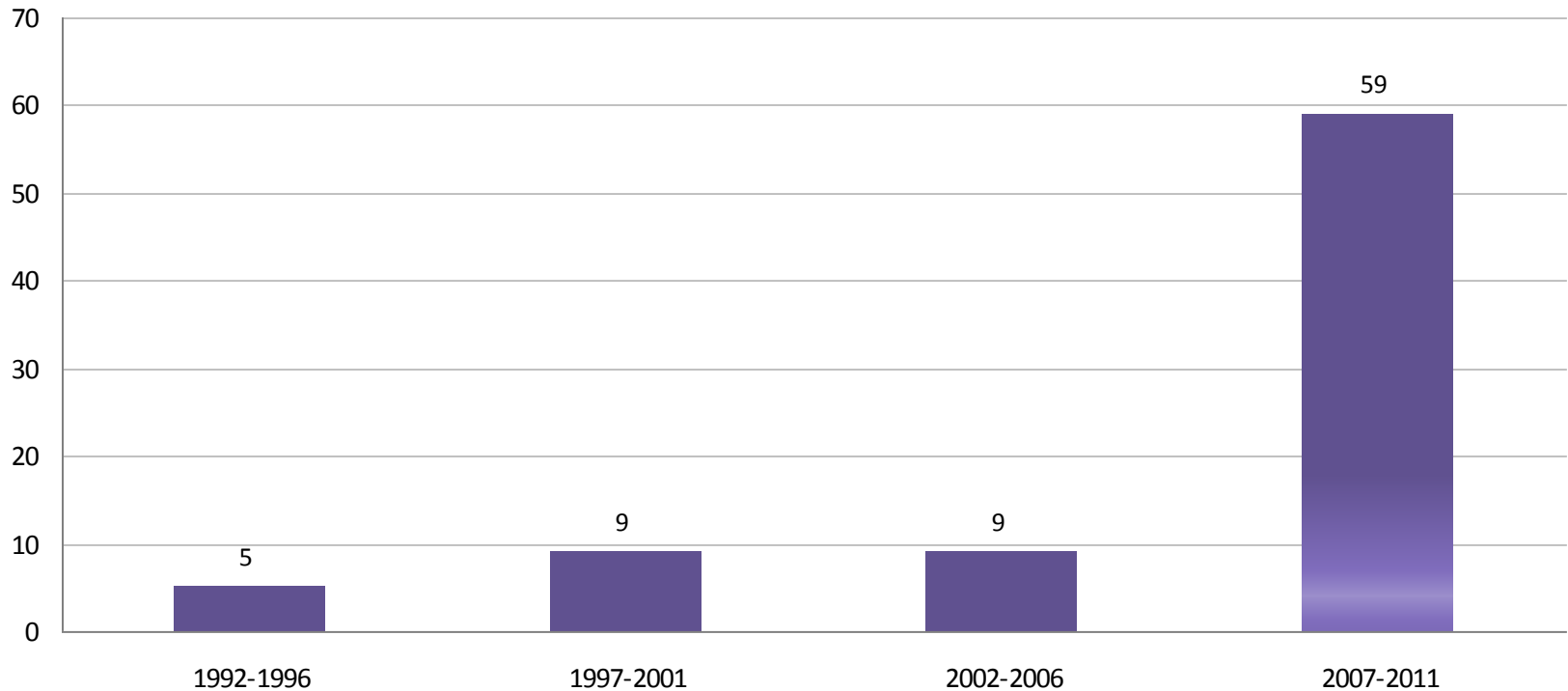
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FCPA Compliance: Managing Third Party Risk

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January 31, 2012

More Enforcement Actions Being Brought Involving Third Parties

Combined Enforcement Actions Against Corporations Involving Third Party Intermediaries
1992 through 2011



“Directly or Indirectly”

Vicarious liability for the acts of third parties:

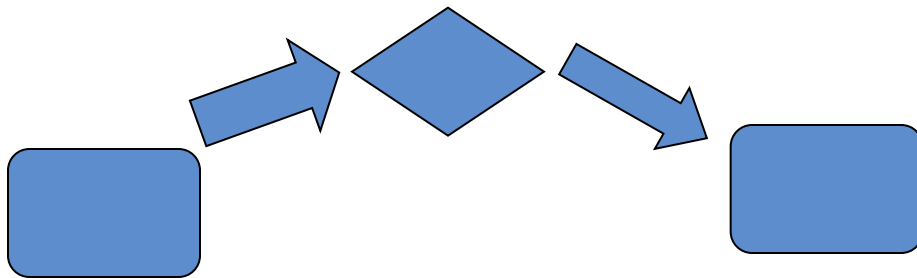
- Agents
- Sales representatives
- Consultants
- Subsidiaries
- Lawyers
- Accountants
- Joint venture partners
- Relatives of officials
- Others

As Applied: *Directly or indirectly*

Under the FCPA, a company or individual can be liable for payments made by a third party (like a consultant) if there was awareness of a “high probability” that a payment would be made.

How can you be aware of a high probability?

- Hiring a 3rd party who was likely to pay
- Failing to investigate 3rd party risks
- 3rd party payments contrary to company policy
- 3rd party agrees to demand for payment



Third Party Risk: Joint Ventures

- Level of investment and control important
- Due diligence can be difficult depending on bargaining power
- Due diligence essential to facilitate proper agreement safeguards upon entry into the JV
- ***RAE Systems*** shows need to conduct due diligence prior to formation, as well as need to implement safeguards in response to the due diligence findings

Third Party Risk: Professional Advisors

- Professional consultants and advisors create can create FCPA risks
- ***Baker Hughes*** involved bribes paid by the local Indonesian affiliate of KPMG to tax officials to reduce the Company's tax bill, disguised in an inflated KPMG invoice
- ***TSKJ Bonny Island*** scheme involving Halliburton/KBR and others funneled bribes to Nigerian officials in part through Jeffrey Tesler, a U.K. lawyer

State-Owned Enterprises as Third Parties: Design Institutes

In some countries, your third party may be a state-owned enterprise, raising additional compliance risks and due diligence challenges

Rockwell Automation highlights compliance challenges of working with Design Institutes:

- Employees of wholly-owned subsidiary, RAPS-China, made payments to employees of Design Institutes through third-party intermediaries
- The Design Institutes provided some bona fide services to RAPS-China
- The Design Institutes also offered recommendations to RAPS-China's anticipated ultimate customers, i.e., Chinese government-owned mining companies
- RAPS-China's Marketing and Sales Director intended the payments to influence the award of sales contracts

Third Parties Everywhere: Diageo 2011

Diageo's 2011 settlement revealed its use of various third party structures to make improper payments:

- In India, Diageo's **subsidiary** used distributors and other third parties to make improper payments to officials to increase sales of liquor to government-run stores
- Payments were funded through inflated commission payments to **distributors**, who passed on the money to officials.
- In Thailand, Diageo's **joint venture** made payments to an **official's consulting firm** (including reimbursement for entertainment expenses) for the official's lobbying services to resolving tax disputes (the accounting records concealed his direct involvement).
- In South Korea, Diageo's subsidiary provided cash, travel and entertainment to customs officials to obtain a favorable tax rate, including kickbacks paid through their **customs broker**. Travel for these officials included a purely recreational side trip to Budapest and Prague.
- The Korean **subsidiary** also made hundreds of small "rice cake" payments (in cash or gift certificates) and "relationship" payments to South Korean military officials involved in liquor procurement.

What is the Goal?

Mitigate FCPA risk presented by third parties who will stand between you and foreign officials, recognizing that third parties:

- may not share your commitment fully; and/or
- may not appreciate the vigilance and adherence to process required to protect against violations; and
- are not fully within your control

What Are Key Characteristics?

- Design a process that:
 - Covers the appropriate universe of third parties
 - Is tailored to risk
 - Is tailored to resources (cost and time efficient)
 - Can be implemented consistently across the organization
 - Generates an adequate written record
 - Provides for centralized knowledge at some level
 - Provides for periodic updates
 - Effectively protects the organization against risk

What are the Questions to be Answered?

- Why do we need a third party?
- Why do we need/want this third party?
- What is the value of this third party's services?
- What are the reasonable ways to pay for that value?
- How do we ensure that the third party provides the value for which we are paying?
- Will this third party conduct business consistent with our ethical and legal obligations, and our expectations?
- How have we protected ourselves against the risk that we are making the wrong judgment?

Addressing Third Party Risks: Due Diligence Policies/Procedures

- Pre-engagement due diligence
 - Internal proposal
 - Internal reference check
 - Questionnaires and verification
 - Interview(s)
 - External reference checks
 - Public data searches (incl. local press and “blacklist”)
 - Local law check
 - Identification/investigation of specific “red flags”
- Notification of company gatekeepers

Addressing Third Party Risks: Due Diligence Policies/Procedures

- Benchmarking/justifying proposed compensation
- Interviews
- Written contract requirements
- Incorporation of safeguards to address red flags
- Measures consistent with level of control for JVs
- Address process for monitoring, audits, and updates at formation
- Multiple company approvals/sign-offs
- Awareness training (for third parties and “minders”)

Accounting Provisions: Internal Controls

- Payments contrary to company policies (*Chiquita*)
- Payments without prior due diligence (*InVision*)
- Failure to document payments (*Titan*)
- Failure to provide FCPA training to consultant (*Oil States International*)
- Failure to implement adequate internal controls at JVs and subsidiaries post-acquisition (*RAE, Diageo*)
- Misrepresenting payments to third parties in books and records (e.g., recording bribes paid through distributor as “commissions”) (*Diageo*)

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Third Party Due Diligence

Defining and reevaluating your due diligence for third parties



- ◆ Weighing third party risks to develop a “risk-based” approach
- ◆ The number of due diligence procedure sets that a company should maintain
- ◆ Content and analysis of a due diligence file

Weighing the risks presented by third parties



- ◆ Geography

- ◆ Your company's industry

- ◆ The type of third party
 - The third party's industry
 - Representative capacity

Distinguishing third party representatives from other third parties



- ◆ Greater responsibility/liability for representatives' actions
- ◆ Representative relationship vs. independence = question of representative capacity
- ◆ Higher level / greater appearance of representative capacity merits a higher level of due diligence
- ◆ Representative capacity for
 - Dealings with governments and government officials
 - Customers
 - Resellers can be both a customer and a representative in certain situations

Most common types of third party representatives



Type

- Commercial Consultants
- Processing Consultants
- Professional Consultants
- Mixed Consultants
- Other Vendors?

Activities

- General sales, government sales, marketing
- Customs, visas, licensing and permitting, freight forwarding, shipping
- Legal services, accounting
- Distributors, joint venture partners, joint ventures, some subcontractors

Three types of procedures – due diligence process for third party representatives



Extensive pre-retention due diligence requirements pertaining to, as well as post-retention oversight of, all agents and business partners, including the maintenance of complete due diligence records at the company

– FCPA Review Opinion Procedure Release No. 04-2 (July 12, 2004)

- ◆ Pre-engagement process
- ◆ Oversight and re-evaluation
- ◆ Recordkeeping

Additional standards may apply for each procedure set based upon risk profile and emergency situations

Considerations – due diligence process for third party representatives



- ◆ Coverage – representatives to whom?
- ◆ Commercial value
- ◆ Dedication of adequate resources
- ◆ Purpose – choose only third party representatives that do not commit bribery
- ◆ Implementation
- ◆ Frequency of secondary reviews
- ◆ File access and maintenance
- ◆ Common sense and pragmatism

- ◆ FCPA due diligence analysis for all representatives will include the following steps:
 - Step One: Consider the reputation for corruption of the country in question
 - Review information from governmental organizations
 - Review information from non-governmental organizations, such as Transparency International
 - Step Two: Determine the competence of the representative or business partner
 - Qualifications of candidate (expertise, resources)
 - Identification of representative's expected activities

- Step Three: Determine the integrity of the representative or business partner
 - Conduct interview with candidate / internal point of contact
 - Obtain and interview business / financial references
 - Review U.S. and non-U.S. restricted parties lists
 - Media / internet searches
 - Identification of known conflicts
- Step Four: Identify any relationships between the representative or business partner and non-U.S. government officials (and customers)
 - Entity information / documentation
 - Ownership
 - Directors / officers / key employees
 - Past and present relationships with government agencies

- Step Five: Determine the business justification and reasonableness of compensation and payments
 - Terms (commission, term, territory, etc.)
 - Business justification (current opportunities in territory, how candidate was identified, etc.)
- Step Six: Ensure that answers provided by the representative or business partner to due diligence questions are accurate and complete.
 - Verify information received from consultant with interviews of business references and background search

- Step Seven: Ensure compliance with local law
- Step Eight: Integrate FCPA safeguards into the representative's or business partner's agreement
- Step Nine: Provide for continuing oversight of the activities of the representative or business partner – a “sponsor” for all representatives must be assigned and will be responsible for ensuring continuing oversight
- Step Ten: Ensure maintenance of accurate books and records

- Step Eleven: When appropriate, consider seeking guidance from the Department of Justice under the FCPA Review Procedure
- Step Twelve: Use consistent standards and common sense
- Notes:
 - Specific level and type of due diligence that is required for each representative and business partner will vary.
 - Circumstances may compel additional due diligence and/or oversight efforts on a case by case basis.
 - Due diligence is not a one-time activity. Periodic refreshing of due diligence and ongoing oversight is essential.

Example – Parker Drilling’s compliance review files



- ◆ Employee sponsor prepares:
 - Business justification form
 - Internet research
- ◆ Third party representative completes:
 - Acknowledgement letter
 - Applicant questionnaire
 - Affiliated parties charts
 - Reference forms
- ◆ Compliance Department prepares:
 - Restricted parties screening report
 - Independent investigative report (mid-level risk) or legal opinion (high-risk)
- ◆ Legal Department prepares:
 - Final draft of contract with third party representative
- ◆ Employee sponsor, Legal Department and Compliance Department prepare:
 - Compliance enhancement memoranda

