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In This Issue:

Baker & McKenzie's quarterly corporate compliance publication, "Inside the FCPA," is an electronic and hard copy newsletter dedicated to the critical examination of developments in U.S. and international anti-corruption compliance that are of particular concern to global companies (and their officers and employees). The newsletter is written with the intention of meshing specialized U.S. coverage with a select international viewpoint in order to meet the expectations of an international client base and a discriminating readership. We seek to make our guidance practical and informative in light of today's robust enforcement climate, and we encourage your feedback on this and future newsletters.

If you would like to provide comments, want further information about the matters discussed in this issue, or are aware of others who may be interested in receiving this newsletter, please contact Sue Boggs of Baker & McKenzie at sue.boggs@bakermckenzie.com or +1 214 965 7281. We look forward to hearing from you and to serving (or continuing to serve) your FCPA, international anti-corruption, and corporate compliance needs.

Monitoring Bribery Risk Through the Audit Right Process

By Reagan Demas*

With the increased scrutiny on third party relationships from U.S. and foreign regulators, a company's right to audit the books and records of its third party vendors, agents, and other business partners is paramount. Audit rights are often touted as critical components of any compliance program, but they can also be burdensome to all parties involved. For a third party forced to open its books to scrutiny, they are an intrusive and time-consuming prerequisite to doing business with global companies critical to their survival. For the company that wishes to manage its third party partners, audit rights are a challenge to negotiate and an increasing burden on internal financial and human resources when exercised. This article explores the impact of audit rights on both a company and its third party vendors, as well as how global companies can exercise audit rights in an effective and efficient manner with minimal disruption to both the third party and the company's bottom line.

The Nuts and Bolts of Negotiating Audit Rights

Audit rights are an important part of a company's compliance "insurance policy." In the event of an allegation of impropriety, a company will be expected to be able to access and review all records relating to business activities, including those records held by agents, distributors, and other intermediaries.

Negotiating effective audit rights in contracts with third parties can be challenging. Many third parties resist them entirely, while others want them to be watered down until practically non-existent.

There are several ways to negotiate practical audit rights provisions in a manner that allays concerns by the third party, while also maintaining the company's right to access the information it needs. One of the more common concerns third parties express relates to privacy considerations. Companies can alleviate this concern by agreeing to sign a confidentiality agreement prior to the audit, and agreeing to review records in accordance with all applicable laws.

Other concessions may be required by the third party, many of which can be agreed to without compromising the integrity of the audit rights. A company can require that reasonable notice be given to the third party prior to an audit, and agree that the company will cover all costs associated with the audit. In certain circumstances a company can agree not to copy or remove any documentation from the third party's offices, or limit the time allotted for the review. In the latter instance, it is important that adequate time is allotted to ensure a complete review of the anticipated volume of records.

In addition, some third parties may ask that the audit provision only allow for an audit under certain circumstances (*e.g.*, an investigation by authorities or an allegation of impropriety). While some limitation can be negotiated, companies should be certain that they maintain discretion to invoke an audit sufficient to cover all anticipated circumstances.

For instance, audits permitted only in the event of a subpoena are ineffective in the compliance arena because internal investigations are often required to be conducted prior to involvement of regulators. Limiting compliance audit rights to instances where warranties or other terms in the agreement are alleged to have been breached can be effective in certain circumstances where the third party balks at broader rights language. An agreement that only a "material" breach will authorize an audit is not advisable due to the subjective perception of materiality. Many third parties ultimately insist on reciprocal audit rights, so companies must negotiate these provisions with an eye towards limiting the possibility that those terms could be used as a harassment tool against the company.

In many instances, a third party will work to limit the scope of the audit to selected information relating to compliance with the contract's basic terms and conditions. Limiting audit rights to price, delivery, and other basic terms is ill-advised as it effectively nullifies the substance of the provision from a compliance perspective. It is important that the company be able to access all financial records relating to the third party, particularly details of cash disbursements. Similarly, in the context of a joint venture, it is beneficial to include the right to audit the books and records of the partner entity as they relate to the joint venture and not solely the right to audit the books of the joint venture itself. These scoping discussions must be undertaken before the contract is signed, not at the time an allegation of impropriety is raised.

When and Where to Audit: Assessing Risk

Determining which third parties warrant the attention of an audit differs for each company based on its appetite for risk. Companies that do business in industries with a history of government enforcement generally know the risks and understand that a low risk tolerance will serve them well in the long run. Other organizations with limited exposure to regulatory bodies may be more amenable to risk and less willing to spend time and financial resources engaged in the compliance audit process.

In order for such companies to gauge risk and make informed choices regarding when to negotiate, implement, or exercise audit rights over third parties for compliance issues, they must first conduct a risk assessment to determine which third parties to review, and under what circumstances to conduct these reviews. An appropriate risk assessment should be mapped out in advance and will differ from company to company, but any risk assessment should include certain key elements when determining where and when to deploy compliance resources, including geography and the nature of third party relationships.

Geography

The geography in which a company operates plays an important role in assessing compliance risk. Companies succeeding in today's global market environment are doing so often by way of expansion into the fast-growing economies of emerging markets. It is well documented that doing business in such markets comes with a heightened degree of corruption risk, due in part to the high number of state-owned businesses operating in these regions.

Nature of Third Party Relationships

In assessing third parties to be audited, certain relationships are considered to pose higher risks than others. Many companies use third party sales and marketing agents to sell their products to customers, while others rely on distributors and resellers to channel their products through the supply chain. Once items are sold, logistical third parties, such as freight forwarders and customs brokers, are often used to move products across oceans and borders to their final destinations.

Utilization of third parties can be critical to the success of an organization, but history has shown that use of certain types of third parties can increase the likelihood that improper payments will be made to officials. Over the past two years, the U.S. Department of Justice and the U.S. Securities and Exchange Commission have brought numerous actions against companies for the acts of associated third parties, including Panalpina, Daimler, Alcatel-Lucent, Johnson & Johnson, ABB, Innospec, Alliance One, Diageo, and Maxwell Technologies. Companies are therefore wise to carefully assess the risk of their specific third parties and structure their compliance audits to ensure that the highest-risk third parties are audited thoroughly and frequently.

Communicating and Scoping the Audit

When auditing third parties on compliance matters it is important to communicate intentions early and often. This entails internal and external communication with both the business unit utilizing the third party's services and the third party directly. Internally, it is important to gain the business unit's support and to provide it with a clear understanding of the purpose and potential benefit compliance audits can provide.

Depending on the nature of the audit, the General Counsel's office should be a part of these communications from the start. Communications with the third party should be geared towards alleviating concerns surrounding confidentiality and business interruption and a clear expression of the scope of records needed to be reviewed.

Privileged or Not Privileged?

When conducting audits of third parties, it is important to determine early in the planning stages if any risk of future litigation or regulatory scrutiny exists. If the audit's scope includes reviewing the third party's compliance with anti-corruption issues or relates to specific allegations or evidence of impropriety, conducting the audit under the direction of counsel should be considered in order to cloak the exercise in the protection of attorney-client privilege.

This supervision can come directly through the General Counsel's office. In certain circumstances, however, conducting the audit through outside counsel may be warranted – for example, where independence of the review is an issue. In either instance, if at any time during the audit, evidence of improper or illegal activity comes to the auditors' attention, and may require a separate or more in-depth investigation, the current audit should cease until legal counsel can advise on the appropriate next steps.

Conducting the Audit

In order to conduct the most efficient audit (both in time and cost), it is imperative to complete as many of the audit steps as possible prior to arriving at the third party site. Some things to consider prior to the beginning of fieldwork include:

- Interview key business unit personnel who oversee the third party relationship and understand any known issues in the relationship. Determine if any company employees are related to or have a close relationship with the third party. Review expense reports of key account personnel to ensure no self-dealing or inappropriate entertainment is present.

- Provide a written questionnaire to the third party (if not already done as part of due diligence) or, if necessary, interview the third party to obtain key information concerning its business; for example: company ownership and structure, the use of consultants or employees who are associated with the government, the type of accounting system utilized and where accounting records are located, and whether the third party has any large recreational assets.

- Obtain and review copies of the third party's anti-corruption and ethics policies and procedures, including its policy on gifts and entertainment;

- Request an electronic copy of the general ledger to run data analytics and narrow the population for on-site review.

As the audit proceeds to the on-site review, the auditor should already have a clear understanding of the third party's operations. While on-site, the auditor should not only focus his or her attention on the face of the invoice, but rather analyze the purchase orders that make up the invoice, and determine who is requesting the service and whether they are authorized to make such a request. The review should ensure that the control functions are working properly and that the invoice, purchase orders, and voucher packages have all the appropriate approvals. The review should not simply evaluate whether backup documentation and some approvals exist, but also whether that backup demonstrates that appropriate processes were followed and adequate approvals were received.

Reviewing Financial Records: Anything of Value

The review of a third party's financial records should focus on how assets, cash, or anything of value could have benefitted unwarranted parties. The most prevalent vehicle for illicit benefits is cash, but bolder third parties may write checks directly to officials. In past regulatory actions, payments were frequently channeled through another third party (consultant, broker, agent) or paid directly to a vendor (travel agent, educational institution) as a perk for an official, and then masked within the books and records of the third party. The auditor should focus the review on cash disbursements and attempt to identify payments to "out of the ordinary" sources, which may include:

- Payments to consultants who have been put on a retainer, with no apparent associated value;
- Frequent or recurring payments made in dollar amounts that are under approval thresholds;
- Payments made to third parties that are paid outside the Vendor Master File;
- Payments to an account outside the country where the service was provided;
- Payments appearing in excess of fair market value for the services/goods provided;
- Payments made in larger round numbers.

Payments made outside the Vendor Master File present heightened risk. These payments -- often referred to as one-time payments, select payments, or non-recurring payments -- pose a high risk to the organization as the vendors who receive these payments are less likely to have been properly vetted in conformity with the company's due diligence process.

In addition to cash transactions, the use of company assets by third parties should also be closely examined. For example, many companies have hunting lodges, ski lodges, boats, and/or airplanes at their disposal, and the provision of these benefits to third parties that may have a connection to foreign officials must be tightly controlled and monitored. Auditors should ensure that a detailed log or system is in place to track the usage of such assets and that proper approvals are present.

Reporting and Finalization

Documentation and memorialization of the audit process and findings should be prepared at the conclusion of the audit. In many instances, two reports should be prepared: one report to the third party directly and a second, more detailed report, to company management for purposes of internal reporting.

The report to the third party should address any instances of non-compliance with the parties' agreement and suggest remediation steps. The initial step in this reporting process should be a face-to-face meeting with representatives of the third party. In this meeting, the auditor should outline the findings and provide the third party with a detailed packet of documentation supporting those findings.

It is important for the business unit representatives who have direct contact with, and responsibility for, the third party to be involved in the reporting process. This will facilitate expedited resolution of any issues. In many instances, the identified exceptions may be resolved during the initial exit meeting. Before a report is delivered to a third party, it should be forwarded to the General Counsel's office for review and comment. This should be done regardless of whether the original audit was conducted under the direction of outside counsel.

The second report prepared after an audit is for internal use only and should provide a detailed outline of the audit processes and methodology utilized. This report will document the work flow and outline the scoping procedures followed during the review. It should also spotlight the risks the company faces in continuing to conduct business with the third party. If certain high risk factors are noted during the audit, it is particularly important to draft a well-documented exit plan so that the company is adequately prepared to respond when a third party fails to appropriately remediate those issues.

Conclusion

Audit rights are an important weapon in a company's third party compliance arsenal. An effective third party audit program should cover the following points:

- Create and implement a practical, effective risk assessment methodology to identify critical third parties and determine the audit population;
- Consistently apply the approach across its population of third parties;
- Communicate often with third parties and internal stakeholders to ensure a successful and efficient review of the third party relationship;
- Ensure the scope of the audit covers all potential areas of risk exposure;
- If problem areas are identified, ensure they are remediated in a timely fashion;
- Maintain a well-documented exit strategy ready to execute if the risk of doing business with a particular third party is deemed excessive.

Only by ensuring all critical aspects of a model third party audit program are achieved can a company effectively manage the risks associated with operating in today's global marketplace.

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***This article was modified from a piece co-authored by Mr. Demas and Douglas Small of Capstone Advisory Group, as published on Ethisphere.com in June 2012.*

Eye on Australia: A Snapshot of Anti-Corruption Enforcement in 2012

By Mini vandePol and Angela Sevenson, Melbourne

The Australian Anti-Corruption Landscape

The Australian anti-corruption landscape is experiencing rapid change. In the 1980s and 1990s, successive State and Federal Governments in Australia concentrated on domestic anti-corruption measures. However, foreign corrupt practices have attracted greater focus in recent years for a number of reasons, particularly the following:

- The prominence and prevalence of international enforcement, particularly by the U.S.;
- Increased globalization of Australian companies;
- Criticism leveled by organizations such as Transparency International at Australia's lack of enforcement of its bribery laws;
- Media exposure of bribery and corruption events involving Australian companies in their overseas operations; and
- Shareholder class action law suits arising from publically listed companies failing to disclose issues of bribery and corruption to the market.

In November 2011 Baker & McKenzie's Australian offices commissioned and launched a report entitled "**Bribery: Do Australian Companies Take it Seriously?**" The report explores how C-Suite and senior executives from 81 Australian companies navigate foreign corruption risks. A key finding of the survey was that the anti-corruption compliance procedures of Australian companies in high risk industries, such as mining and resources, operating in high risk jurisdictions, such as China and India, were poorly implemented. A primary reason for the lack of focus on this area was that no enforcement of applicable Australian laws had yet occurred, and accordingly anti-corruption compliance was not perceived as high a priority for Australian companies when compared, for example, to health and safety or antitrust issues.

Structure of Australian Anti-Corruption Laws

Australia has both State and Federal anti-corruption laws that prohibit public sector bribery of local or foreign public officials and corrupt private sector commissions. Corporations may now be fined up to A$11 million or triple the value of the illicit benefit or (where the illicit benefit cannot be determined) 10% of annual turnover in the year preceding the offense. An individual now faces a maximum penalty of 10 years imprisonment or fines of up to A$1.1 million.

Under Australian law, and only in relation to the offense of bribery of a foreign public official, there is a defense that permits facilitation payments (sometimes called “grease” or “speed” payments). One of the conditions required to establish this defense is that the company keeps accurate records in connection with any facilitation payments. However, following a review conducted in late 2011, the Australian government is considering whether to remove the facilitation payments defense. In light of the U.K. Bribery Act, which prohibits facilitation payments, and the many other countries that are following suit, Australian companies who are global players, such as Rio Tinto and BHP, are already incorporating a "zero tolerance" policy with respect to all forms of bribery, including facilitation payments.

Compared to the U.S. and the U.K., Australia does not have an extensive body of legal precedent to draw on regarding criminal anti-corruption matters. Australia also does not have regulatory bodies, such as the U.S. Department of Justice or Securities and Exchange Commission, or the U.K.'s Serious Fraud Office, charged with investigation and guidance in relation to these matters.

Suppression orders, decisions not to prosecute, and a historical reluctance by the Australian authorities to enter into public dialogue have all clouded the Australian anti-corruption enforcement landscape and created uncertainty for Australian businesses with respect to compliance program requirements. This uncertainty has loomed increasingly larger as Australian businesses expand their operations into countries with a particularly heightened risk for corruption.

The evolution of both the Australian authorities' approach to combating corruption and Australian companies' awareness of anti-corruption compliance risks can be seen in the contrasting enforcement approaches and outcomes of the 2005 Cole Inquiry and the 2012 Securency and Note Printing Australia case.

The Cole Inquiry

The 2005 Cole Inquiry (a Royal Commission) into the Australian Wheat Board (AWB) Iraq Oil-For-Food scandal and resulting civil law suits probably remain the most well-known foreign corruption inquiries and shareholder law suits in Australia. Essentially, the Cole Inquiry determined that AWB, a publically listed Australian company, knowingly paid Saddam Hussein's regime almost A$300 million in kickbacks.

Despite this finding and after many years of investigation, the Australian Federal Police ceased their review into the conduct of the directors and employees involved. The Australian corporate regulator has pursued several directors for breach of their director's duties, and AWB shareholders launched a class action law suit for breach of AWB's corporate disclosure obligations.

The shareholder case settled for A$40 million. Significantly, no criminal charges were ever filed against AWB or any of its officers, directors, or employees allegedly involved in the kickback scheme. Earlier this month, however, civil charges brought by the Australian Securities and Investment Commission against two directors of AWB resulted in civil fines and temporary disqualification from managing the affairs of a corporation. Despite the civil charges, as a general matter, the outcome of the AWB bribery scandal did little to alert Australian companies as to their own risks in relation to bribery and corruption compliance.

Case Study: Securency and Note Printing Australia

Following detailed media reports by investigative reporters for *The Age* newspaper, charges were brought in June 2012 against Securency International Pty Ltd (Securency), Note Printing Australia Limited (NPA), and nine senior executives for allegedly bribing foreign officials in order to win banknote supply contracts. This has been a watershed development in Australia's enforcement of its foreign corruption laws. Securency and NPA are subsidiaries of the Reserve Bank of Australia, the nation's central bank. NPA prints banknotes on polymer substrate produced by Securency.

The Securency and NPA cases mark the first time that criminal charges for bribing a foreign official have been brought against a corporation under Australian law and the first time an investigation of this nature has generated any arrests. The charges against the corporations carry a maximum fine of A$330,000 per offense -- significantly less than would be the case if the conduct occurred post-2010 when substantial increases were made to such penalties, and also notably less than what many might consider sufficient to deter others. The application of sentencing principles may also result in further reductions to the ultimate fines.

While many details of the proceedings, including pleas and sentencing, cannot be revealed due to the abiding Court's suppression orders, it is clear that the prosecutions have raised greater awareness in Australian companies of the risks of bribery and corruption. The former Company Secretary and Chief Financial Officer of Securency is reported to have turned prosecution witness. Committal hearings involving the individuals charged commenced on August 13, 2012, and are expected to last for two months.

A Nexus of Anti-Corruption Events: Impetus for Permanent Change?

The final outcome of the Securency and NPA cases is likely to have a significant impact on many aspects of Australian anti-corruption compliance. So too will the result of the U.S. Justice Department's investigation into prominent Australian mining company BHP, which is expected to be released this year.

If Australian companies understand that they are at risk of prosecution in multiple jurisdictions, including by Australian authorities at home, this may focus greater attention on addressing compliance risks. We are already seeing further media allegations of bribery and corruption involving other prominent Australian companies in the defense, construction, and mining industries, which are under investigation by the Australian Federal Police.

The timing of this investigation activity has also coincided with the visit by the Organization for Economic Cooperation and Development (OECD) Working Group on Bribery in May of this year to review Australia's anti- bribery enforcement paradigm. The review team interviewed stakeholders about general views on Australia's anti-bribery enforcement, general awareness of the foreign bribery laws, opinions on the measures in place to detect and combat foreign bribery, and any relevant challenges experienced.

The publication of the full OECD report should again draw attention to the challenges faced by Australian companies in this area. Indeed, if the OECD recommends the abolition of the existing facilitation payment defense, this may force the Australian government to get off the fence and take action. If the Australian government does abolish the facilitation payment defense, many Australian companies will need to quickly adopt a different approach to their overseas business operations and to their oversight of the business conducted on their behalf by agents and intermediaries. Like the impact of the U.K. Bribery Act, these events may be the wakeup call needed to change the Australian landscape once and for all.

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Our Corporate Compliance Practice Group

Baker & McKenzie's North American Compliance team offers a comprehensive approach to assessing and resolving compliance related issues -- including everything from program building and prevention to investigations and remediation. Our team advises clients on the full range of issues relating to the FCPA, such as structuring transactions and commercial relationships to comply with the FCPA, developing and implementing FCPA compliance programs, establishing and conducting FCPA training programs, conducting internal investigations, advising corporate Audit Committees, and representing corporations and individuals before the Department of Justice, the Securities and Exchange Commission, and international regulatory bodies. The firm's extensive global network allows us to deliver FCPA-related services from offices in the overseas jurisdictions where issues arise, which in turn provides valuable local expertise on laws and culture, along with significant savings to our clients. Our coordinated approach combines a formidable presence in Washington, D.C., with a vast network of experienced lawyers throughout the globe.