The FCPA REPORT

www.fcpareport.com Volume 2, Number 19 September 26, 2013

Third Parties

Conducting Effective Anti-Corruption Due Diligence on Third Parties: An Interview with Principals at Nardello & Company

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Most companies doing business multi-nationally must engage third parties to operate on the company's behalf overseas, but in the current anti-corruption landscape, third parties can be a necessary evil. Under the FCPA, a company can be held responsible for any improper payments made on its behalf by a third-party agent or partner, and many recent FCPA enforcement actions by the SEC and DOJ have involved the actions of third parties.

To best protect themselves from the risks associated with retaining third parties, companies must devote significant resources to the critical and complicated task of conducting due diligence. How should a company efficiently allocate its due diligence resources? How can a company effectively gather information in challenging jurisdictions? What should a company do if it does not wish to inform a prospective agent that it is conducting due diligence?

The FCPA Report is publishing a series of interviews with experts from different disciplines on best practices for conducting anti-corruption due diligence on third parties. This article, the second in the series, includes our interview with Nardello & Co.'s FCPA team: Daniel Nardello, Tara MacMillan, Nicholas Peck and Michael Ramos. Nardello, MacMillan, Peck and Ramos are all seasoned investigators with extensive experience in anti-corruption initiatives. Nardello and Ramos also both formerly served as prosecutors in the Southern and Eastern Districts of New York, respectively. The first article in the series contained an interview with Alice Fisher, a partner at Latham & Watkins and former head of the Criminal Division at the DOJ.

FCPAR: In your experience, what are the government's expectations with regard to third-party vetting?

Nardello: That's a tough question because the DOJ, although it has put together guidelines about doing adequate third-party due diligence, has not provided a defined set of standards for what that means. I think that this is one of the trickiest areas for companies because I don't think anybody can tell companies when enough is enough and what is too much.

I don't think the government has articulated what is sufficient. As a former prosecutor, I believe that the more due diligence a company does, the better off it is going to be if something goes pear shaped. But, it is hard to determine at what point along that spectrum the government will say, "enough is enough." I doubt if the government wants to tell companies that.

FCPAR: Why do you think the government chooses to leave that gray area?

Nardello: They don't want to get in the business of telling companies how much they should do. Their view is, "You're a big boy, you have a company, you figure out what's appropriate under the circumstances. You have proper legal advice, it's not proper for us to tell you what to do." Being vague also gives them maximum flexibility when making prosecutorial decisions.

Peck: I believe it also keeps companies from manipulating the system. Once the government provides a specific set of requirements, companies will figure out how best to get around them and that defeats the purpose.

FCPAR: What are some examples of third parties on which companies should focus their due diligence efforts?

Nardello: Corporations should focus on all agents that have contact with the government on its behalf.

Peck: Companies should also focus on whether an agent has other government contracts, for example whether it needs licenses from the government to operate.

FCPAR: Are there any types of agents that companies tend to overlook when performing due diligence? [See e.g. "Six Steps for Converting a 'Paper' FCPA Compliance Program into a Pervasive Culture of Anti-Bribery Compliance (Part Two of Two)," The FCPA Report, Vol. 2, No. 5 (Mar. 6, 2013).]

Peck: Companies often don't think about the agents who are already in place. They think, "I've been working with that guy for ten years," and don't think to do a due diligence investigation.

Nardello: That's a very good point. In addition to basic diligence, when examining existing agents, companies should consider whether there is even any point in having that agent. We once had a client who asked us to look at all their intermediaries. One of the things the exercise revealed is that, putting aside whether there were problems with the agents, there was no business case for many of the agents. In essence, the company didn't need them. They had outgrown their utility, they had stopped being productive, or the business had changed in that jurisdiction, but the agents were still doing business or were still on the books as agents. The company had many people signed up as agents who were serving no business purpose – their only purpose was to be a potential FCPA violation.

FCPAR: Do you think a company's due diligence procedures and policies should be written?

Nardello: Nowadays they have to be written because a corporation has to be able to prove that they exist. Additionally, if a company is serious about due diligence, particularly big multi-national corporations, the policies have to be written, they have to be communicated to employees, and people have to be able to consult them.

FCPAR: Do you recommend differentiating between low-risk third parties and high-risk third parties when performing diligence? Should companies use some type of coding system to differentiate risk levels, such as red, yellow or green, or using a numbering system to rate risk? [See "Lessons Learned by Motorola Solutions, ExxonMobil and VMWare on the Role of Risk in Designing and Implementing an FCPA Compliance Program," The FCPA Report, Vol. 2, No. 15 (Jul. 24, 2013) (discussing the benefits and drawbacks of coding risks).]

Nardello: Yes, companies have to make some distinctions when performing due diligence, otherwise they would be doing everything on everybody all the time. That would be terrific for our business, but it doesn't seem economically sensible, sustainable or smart. We have clients with very articulated due diligence schedules. They have agents all over the world and they divide them into categories: high risk, low risk, and medium risk.

There are elements that companies can use to categorize types of third parties, but they have to be cautious. For example, companies should avoid broad judgments about particular countries. People tend to think that operating in Western Europe is not as great of a risk as operating in Africa. I disagree. I lived in Italy for six years and did this business and I can tell you, just because people dress nicely, have a modern transportation system and everything is very elegant, the business in Western Europe and elsewhere can be as dirty as it is anywhere in the third world. There are more important elements than geography.

The principal element that multi-nationals need to consider when determining how much diligence is appropriate is to what extent the business is government-facing. Companies should ask, to what extent is the agent going to be dealing with the government? What is the government nexus? Does the agent need to obtain licenses? Some industries have more direct contact with the government than others.

FCPAR: Are there any steps that you would recommend companies take for most, or all, types of agents?

Nardello: The first step is to gather information from the agent. Many companies lack a rigorous articulated method of actually obtaining information from the third party. What we suggest, and what we have prepared, is an exhaustive questionnaire. The questionnaire provides the company with valuable information at a low cost. If the company gives an agent the questionnaire and the agent comes back and says, "I'm not going to answer things about my offshore bank accounts, my prior convictions, investigations or arrests, who I'm a nominee for, who the beneficial owner of my Gibraltar corporation is, and the political affiliations of my sons and my family," the company can save a lot of money. It should not move forward with the agent.

The questionnaire also serves as a statement from the potential third party that the company can then confirm or identify as a lie. That is always important when you're trying to figure out if somebody is telling the truth. It's better to have a statement from them, it makes it much easier to play off against something, either confirm what they are saying or put the lie to it, show that there are inconsistencies.

In situations where a company doesn't want to inform the agent that it is doing anti-corruption diligence, it is possible to get creative. For example, we have clients doing a lot of work in South America. They didn't want to tell the agents that they were conducting an investigation. We came up with what we called a business development form that the company issued. It gathered the same information as a questionnaire, but under the guise of using the information for business development purposes.

FCPAR: Are there other things a company should consider when distributing or evaluating questionnaires?

MacMillan: The questionnaire should ask for pretty much everything including bank accounts, passport numbers and pedigree information. Along with the questionnaire, the company should also request photocopies of supporting documentation such as passports. In my experience, people will write things down that are not always accurate. We had a case where an agent included information about an individual who was actually deceased, but the agent was still representing him as an active person. Having actual copies of documentation can make a big difference in linking up

families, especially in countries where many names are similar.

FCPAR: What else should the company consider when beginning the due diligence process?

MacMillan: It's important to consider cultural issues in the country where the agent is operating. In some situations, it may not be culturally appropriate to ask all sorts of questions. It would offend the agent and make forming a relationship very difficult. [See, e.g., "Representing Foreign Companies in Criminal FCPA Actions: Strategies for Handling the Legal, Practical and Cultural Challenges," The FCPA Report, Vol. 2, No. 8 (Apr. 17, 2013).]

Nardello: Multi-nationals also need to consider whether they will be conducting the due diligence investigation with the knowledge or some participation of the subject of the investigation or if the company doesn't want the subject of the investigation to find out about the process. In culturally sensitive situations, it may not be possible to go directly to the potential agent.

FCPAR: What are some of the due diligence steps you would recommend companies take for third parties deemed low risk?

Nardello: The questionnaire is a good place to start. The company should also look at what we call open source information – the public record, media, Internet, public filings and litigation involving the potential third party where it's available.

MacMillan: If possible, the company should also perform site visits of the potential third party's business. Some companies choose not to do site visits for low-risk third parties, but I think that actually verifying that somebody is where they say they are can be very helpful. It's amazing how things can be represented.

Peck: In some jurisdictions there are going to be records that are easily accessible. In other jurisdictions, companies are not going to get a whole lot unless someone actually talks to people on the ground. Also, in some jurisdictions the local media is not reliable. It's a little tough to set a standard for low-risk diligence because it can vary country-by-country.

FCPAR: What type of diligence should be done for a low-risk third party when the company is in a situation where it doesn't want the third party to be involved in the due diligence process?

Ramos: Open source information is always a good place to start. Even if it's a jurisdiction where the media is unreliable and records are less available, it will still give the company a sense of what's out there on that agent. The company can then step back and formulate the next steps.

Sometimes the comparison of what the investigator uncovers in the public record and what the client knows about the agent can be telling. Even if the agent hasn't filled out a questionnaire for whatever reason, the investigator can come back with information that the client was unaware of. For example, the client may realize that the agent never provided information about an individual serving as a director of the company. That type of information gives the company more questions that it can ask.

FCPAR: Let's turn to high-risk agents and start with the scenario where the agent is involved in the due diligence process. What steps would you suggest the company take?

Nardello: The company should start with everything we discussed for low-risk agents – a questionnaire, public record sources, etc. It is also important to meet the agent in person.

MacMillan: The company can also consider asking local individuals and businesses questions about the potential agent. When we are performing diligence we make inquiries with people that we know to try to get a sense of the agent, of what kind of additional information we should gather and whether what the agent is representing is accurate. Depending on a client's tolerance threshold, we may also talk to other people, former business partners, former employees, etc. It really depends on how deep the company wants to go to verify information.

FCPAR: What would change if a company is investigating a third party that it thinks is high risk, but it does not want the third party to know the investigation is happening. What would you suggest the company do to ensure that it does the proper due diligence?

MacMillan: They can't do the interviews with the agent but they could still discretely do a site visit.

Nardello: The company can still talk to sources but, that will also need to be discrete. There are ways to dig. But, the fundamental thing is really scouring the public record and not in a tick-the-box fashion. It's really looking and understanding what is out there about these people. If the agent is a company or owns a company, do those companies have relationships with other companies? Who are the other beneficial owners of those entities? Are they politicians? Are they government officials? Are they the sons or daughters of government officials? It's the thoroughness of each of these exercises that adds value to the diligence.

FCPAR: When, if ever, do you think it's appropriate for companies to bring in third parties to help them do this research?

Ramos: It is important for multi-national entities. There are just so many nuances to operating in various jurisdictions and what may be public record in China may not be public record in other places. It's helpful to have experts performing the diligence.

Nardello: There are many situations where outside experts can be useful. For instance, if a company is in a situation involving a potential FCPA violation, it may not want its in-house investigator handling it alone for all sorts of reasons. It may want to bring in somebody from the outside who can potentially testify. Outside vendors have different resources in our kit bag. There are virtues of bringing in somebody where privilege attaches, where work product doctrine attaches.

MacMillan: The independence of the vendor can be useful too.

Nardello: Exactly. We don't report to anybody. It's sometimes very hard for people in compliance departments to be independent because they are often playing second fiddle to the business people. Whereas, as outside vendors, we are not beholden to any of the business people in any way, we're not in their chain of command.

FCPAR: Are there any other issues a company should consider when selecting a vendor who provides due diligence related services?

Nardello: I would warn corporations against using vendors who use very commoditized, formulaic due diligence or take a "check-the-box" approach. One of the problems with approaching due diligence in a commoditized, formulaic way is that the results of the diligence, even when there are no real issues, can be recorded in a way that ultimately bites the company in the rear.

For instance, we had a client using a vendor to do first-tier diligence. It was inexpensive and quick, and the vendor indicated red flags if certain things didn't fit in whatever its parameters were. For instance, if the prospective agent was a newly-formed company, that was recorded as a red flag. There may be perfectly good reasons why a potential agent would be a newly-formed company. For instance, it might be a special purpose vehicle that was formed for purposes of fulfilling the contract. Using a check-the-box method, the vendor was flagging things that were not necessarily indicia of corruption. The problem with that is, in the future, a prosecutor looking back may have access to that diligence report. Even if there was nothing to be found at the time, the company now has this report with red flags all over it for innocuous behavior.

What a company or third-party vendor should do is to memorialize enough to show that the company did a really rigorous review and addressed any actual issues. What the company or vendor shouldn't be doing is, for lack of intellectual rigor or analysis, just calling everything unusual an indicia of corruption. It is a very tough area to get right.

FCPAR: How should due diligence be documented? Are there issues a company should be conscious of when it is documenting its due diligence process?

Nardello: Particularly when working with outside vendors, companies should be clear about what type of documentation they want. One of the first things we ask when working with a client is whether they want a written report. Most companies do. Sometimes there are reasons they do not want things in writing.

It's also very important to be cautious about how documents are marked. The first report should always be a draft. Companies managing third-party service providers need to make sure that vendors are not sending a report that purports to be a final report before that is appropriate. The vendor should either discuss the draft with outside counsel or discuss it with in-house legal or compliance counsel because there may be issues that the vendor may raise that the company itself will have answers to.

For example, we had a case with an investment bank doing due diligence in Saudi Arabia. They gave us the name of a gentleman. We did research and found horrific things, then we got on the phone with the business folks and they said, "Oh yeah, we know about that. That's not the part of the family we're looking at. We're looking at the good side of the family."

Companies and vendors also need to be careful about including uncorroborated information in their reports. I've seen reports from other firms in this space that said, "Source A says that Agent X has made payments to the state on behalf of Y company." The statement was very specific, totally uncorroborated, and ultimately completely false. It was incredible! I don't know if the investigative firm had made it up, or if the source was a competitor that had an axe to grind, but there was no effort made to corroborate, in any way, that allegation.

Companies, to the extent that they do diligence themselves internally and when they hire outside firms, have to be sure that whoever is memorializing the findings is making sure the information is corroborated. Companies have to make sure that the document is not just a data dump, but a synthesis of proper and permissible inferences from the information obtained. A company or vendor shouldn't take any fact,

either a positive one or a negative one, and say, "Okay that's what we've got." It has to be corroborated, it has to be analyzed and it has to be placed in the particular local context.

The way we think about corroboration is the way we did when we were prosecutors. A prosecutor can obtain a search warrant or a wiretap application using confidential sources. But the prosecutor has to qualify the source, he or she has to tell the judge who the source was in relation to the subject, how many times the source had been reliable in the past, what the basis of the source's knowledge was, and to what extent the source had an axe to grind. We try to apply the same principles in conducting diligence, because, frankly, if I were a prosecutor looking at a report that somebody had done, that's the kind of thing I would be looking for. What was the rigor of the analysis in that report?

FCPAR: Are there any other documentation issues a company should pay attention to?

MacMillan: Yes, from the client's perspective, when there are internal discussions about agents, the company should think carefully about how those are recorded and/or memorialized. We've seen situations where people in the business units are e-mailing and sharing internal things about agents – those e-mails can be used against the company in the future.

Nardello: Casual discussion, in good faith, that raises questions that are then resolved positively, can be deadly on later review. We've seen, "I'm worried about this and I'm worried about that, let's ask them about this and let's ask them about that." Such discussions are better had over the phone, lest the company find itself in front of a grand jury in ten years being asked: "isn't it correct that you were worried about this and worried about that?"

MacMillan: It is particularly dangerous where a company has that that type of e-mail traffic and then a sanitized, pristine report. It can look like the company is hiding something. E-mail is everywhere, it's discoverable and a potential liability.

Nardello: The other thing that's important, and this is always true when a company or lawyer is thinking about potential criminal prosecution, is there shouldn't be any inconsistencies in the due diligence file. The file shouldn't say in one place that "the guy said X," and in another place "the guy said Y." To the extent there are inconsistencies, they need be teased out and they have to be resolved. Prosecutors always see inconsistent statements as indicia of some sort of nefarious conduct.

FCPAR: How important is it for the company to update the due diligence on the third party?

Nardello: It is very important. In a case that we had a number of years ago in the intervening two years between being retained and having the diligence reviewed, the agent had been elected as a member of parliament and became a government official. Things change. Companies absolutely have to do refresher due diligence.

FCPAR: How often would you recommend that companies do that type of refresher due diligence?

Nardello: That depends. The company needs to use a rule of reason and it's a function of how important the relationship is and where the agent is in the risk matrix. I don't think companies need to do it every six months; every couple of years I think is reasonable.

MacMillan: There are some pretty simple solutions that clients can use to consistently monitor agents. One is to set up media alerts. The company doesn't have to do anything, they set it all up and it will run automatically and the company can see if somebody is named in a litigation or in regulatory or disciplinary actions. It's basically a fancy version of a Google alert.

Peck: The choice to update diligence could also be prompted by a change in circumstances. If an agent is going to take on a more prominent role, or an agent is now dealing with government contracts or taking on a different task, or if it's been a while since the original diligence was done, then the company may want to update it.