



# Global Fraud Report

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The strategic impact of fraud,  
regulation, and compliance



An Altegrity Company

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# The strategic impact of fraud, regulation, and compliance

**Fraud is an ever-evolving threat. Its changing forms inevitably spark new regulatory responses in the ongoing battle between fraudsters, their victims and the authorities. Business must adjust its own compliance efforts to such new marching orders, as part of its role in the fight, even when new legislation all too often is clearer about the ultimate goal than the actual details of its requirements.**

As companies know, however, the risks of fraud and falling afoul of anti-fraud regulation permeate almost all business activity. Addressing them properly therefore affects business strategy in numerous ways. This issue of the Global Fraud Report shines a spotlight on a series of fraud and regulation-related issues both to illuminate specific concerns and, collectively, to provide a better idea of the proper breadth of a strategic response to fraud.

As many of the articles show, to make such a response effective requires action on several levels. An essential start is the underlying attitude toward compliance: it needs to be approached as a tool to engineer a better-run, more profitable company rather than a burden to be endured.

This is likely to help with another key to success: a willingness to devote the time and resources needed to developing a detailed understanding of risks and opportunities in existing, and especially new markets. Depending on the circumstance, for example, a company may find it essential to know how to avoid the dangers of

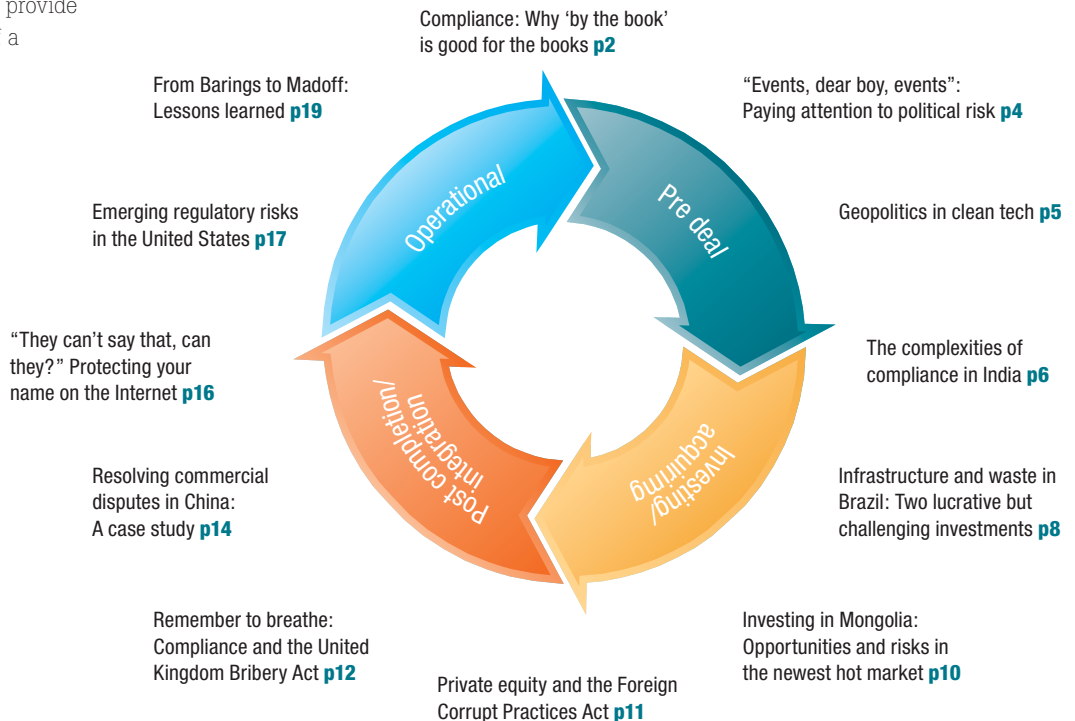


corruption in southern Italy's renewable energy sector, to be able to respond to the complex levers of power within the societies of different Indian regions, or even to be aware of surprising aspects of Chinese corporate law.

Achieving such an understanding is never a finished task. Anti-fraud strategies and compliance programs need to be an integral part of ongoing operations. Their specific form

is inevitably shaped by local exigencies. These are seeing rapid change in major markets from the United States and United Kingdom to Brazil, as well as smaller ones such as Mongolia, which these articles help to explain.

We hope that this edition of the Global Fraud Report provides useful input as you shape a business strategy consistent with the ever-changing regulatory environment.





# Compliance:

## Why 'by the book' is good for the books

By Tommy Helsby

A year ago, the Global Fraud Report highlighted the return of the active regulation of businesses. Tommy Helsby argues that effective controls, far from inhibiting growth, actually build better, stronger business performance.

The past twelve months have brought not only tougher regulation, including the Dodd-Frank Act in the United States and the Bribery Act in the United Kingdom, but also more active enforcement – notably increased resources devoted to corruption investigations in the US at the Department of Justice and the Securities and Exchange Commission as well as a similar business crime focus in Britain at the Serious Fraud Office. Meanwhile, storied magistrates elsewhere in Europe – Joly in France, Garzon in Spain, DiPietro in Italy – have been succeeded by a new generation

of officials keen to make their names. Prosecutors in Germany, often in cooperation with their counterparts in the United States and elsewhere, have successfully targeted a series of major domestic businesses.

In emerging markets, institutional developments may be slower, but public attention to fraud issues, especially corruption, is intense. Looking only at the BRIC countries in just the last few months: in Brazil, both Vivendi and Credit Suisse paid multi-million dollar settlements – without acknowledging wrongdoing – in relation to allegations of investment fraud and insider trading, respectively; in Russia, President Medvedev has proposed that fines in corruption cases should equal up to 100 times the size of the bribe; in India, the Prime Minister, Manmohan Singh, recently bowed to demands to initiate an investigation of corruption in the award of third-generation mobile telecom licenses; and in China, the two top executives of the country's largest e-commerce firm, Alibaba.com, resigned after acknowledging that the company had failed to respond to external fraud issues. Further afield in Asia, 28 governments have now signed up to the Anti-Corruption Action Plan for Asia and the Pacific, overseen by the OECD and the Asian Development Bank.

The exposure for companies operating in emerging markets is not just to local regulators but also to their home regulators acting extraterritorially: corrupt operators cannot rely on lax or venal local prosecutors to turn a blind eye. Indeed, United States prosecutors have successfully pursued non-US companies for alleged offenses committed outside that country when they have been able to show some US nexus or interest. Law enforcement agencies elsewhere have told Kroll that they intend to follow the same path and cross-border cooperation

between prosecutors is now the norm rather than the exception.

Inevitably there has been a backlash from the regulated. Most visible, from where I sit, is the response to the new UK Bribery Act, which will take effect on July 1. The objections seem to me either ill-informed or inappropriate. They are generally some variation of, "I could be arrested for taking my client to a football game" – that won't really happen unless you bribe the referee to get your client's preferred result. People also still insist to me that paying bribes is the only way business gets done in some parts of the world, so aggressive extraterritorial policing of corruption will be a serious disadvantage to British companies operating there. The same argument was voiced by American businesses when the Foreign Corrupt Practices Act (FCPA) was passed forty years ago, yet US companies have remained effective competitors in all those difficult markets.

'Good business' – meaning fully compliant – turns out to mean good business in terms of commercial and financial performance. Siemens, following a massive bribery scandal several years ago, changed its culture (along with many of its senior management), established a dynamic compliance operation, and has been more commercially successful ever since. Even in the most challenging markets, business can be conducted legitimately, and both the deal and the market will be better for it.

There is a broader conclusion to draw from this. Procedures for ensuring that business practices are compliant with the UK Bribery Act or the FCPA should already be in place: a well-run business is already operating comfortably within the requirements of these laws and the only additional requirement the laws bring may be the need to document that fact. The enterprise should operate that way because it is better for the business, not just because the law requires it: opportunities won without corruption are more secure and competitive, and likely to lead to more of the same; corrupt deals are risky, expensive, and vulnerable to further bribe demands or a change of regime.

For the past few years, bribery issues have dominated seminar and conference agendas, in the way that money laundering concerns did for the five years before that. If you measure by the size of the fines, though, competition issues need to be on the list of a company's compliance concerns. If you consider overall cost, in terms of both money and reputation, then environmental regulation remains paramount; trade sanctions have



Although I prefer to leave forecasting to economists and astrologers, I see two other specific issues that should be added to the list. Globalization and communication technology have together changed the game for privacy issues. Regulation, though, is still very inconsistent and local, and compliance is similarly variable. After all, why comply with laws that don't exist? But sensitive data may relate to individuals in one country, be controlled in a second, and accessible in a third: prudence dictates that the highest regulatory standard should apply.

The second issue may be a surprise: human rights governance. This generally sits in the corporate social responsibility agenda, if anywhere, and is often viewed as important but not business-critical. There are, however, movements towards making corporations legally responsible for direct and indirect violations of human rights, such as use of child labor, tacit support for unsavory regimes through trade or investment, or sale of equipment used in repression. The UN's initiatives have been taken up by the OECD, and it may be recalled that the OECD's initiatives on anti-corruption measures have spurred much of the new legislation on bribery.

A well-run business should engage in forward-planning to make sure that the necessary resources and relationships are in place before a problem emerges. By doing so, companies will be less likely to allow current preoccupations to distract them from the wide range of regulatory risks.



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# “Events, dear boy, events”

## Paying attention to political risk

By Jason Wright

In 1914 Henry Noel Brailsford, a prominent British journalist, noted confidently: “The frontiers of our national states are finally drawn. My own belief is that there will be no more wars among the six great powers.” A few months later, those same powers were engaged in World War I, perhaps the most devastating war ever fought between them. This is but one example of the hubris involved in prediction.

Recently, numerous commentators spoke of the security and stability of Hosni Mubarak’s regime in Egypt mere weeks before a national uprising drove him from power. By some criteria, such as the risk of default on Egyptian bonds as measured in the credit default swaps market, Egypt was even rated as a more stable investment than Portugal prior to this revolt.

The consequences of poor foresight apply to businesspeople as well as politicians. World War I brought extensive economic dislocation. Now some foreign investors, particularly those who partnered with businessmen close to the Egyptian or Tunisian regimes, are uncomfortably exposed in North Africa.

The financial crisis was an object lesson in the perils of incorrectly valuing investment risk. As the developed world cleans up the resultant mess, recent events in North Africa provide a warning to investors turning their attention to booming emerging markets to avoid similarly mispricing political risk. Even in some European countries, political risk has become a significant factor; sparked by issues such as protectionist policies in Italy and abrupt regulatory change in the renewable energy sector in several EU countries. How should investors incorporate this risk into their pre-transaction assessments of businesses and into their ongoing understanding of operational risk?

A key point one must recognize is that political risk is not just about revolutions and uprisings;



it is also about less dramatic matters, such as understanding the role of local politicians in authorizing a new plant or the expense imposed by a corrupt political culture in which bribes are commonplace. The link between high levels of political instability and fraud is no coincidence. The same phenomena – such as poor governance, inadequate legal structures, and elites that condone or expect illicit gain – can often induce both.

A second, equally important truth is that political risk cannot be dealt with independently of commercial, legal, or reputational risk. Often a political event has an economic impact. The unrest in Libya, for example, led to a sharp increase in the oil price, creating an economic risk even for countries and companies with limited or no direct exposure to Libya. On a smaller scale, a company competing in an emerging market against a business controlled by the son-in-law of the president may suddenly find that it is subject to new legislation, or that its customers are being “encouraged” to go elsewhere. In such circumstances, any purely commercial analysis of the business that does not take into account these political factors will not provide an adequate model of future earnings.

In fact, companies are increasingly realizing that commercial due diligence projects which fail to take into account political risk, both geopolitical and local, will be an unreliable guide. In the past, investors have tended to commission commercial due diligence, political risk assessments, and integrity or

reputational due diligence from different sets of consultants. These categories, however, do not exist in isolation. A better approach is to examine them together, a service Kroll provides in its integrated due diligence offering.

Due diligence is only a step toward a greater understanding of political risk. Companies, for example, will also need to consider a wider range of extreme scenarios in their planning. No commentator or consultant can predict with certainty what will happen in world affairs, but they can give investors better information and comprehensive analysis to help them deal with the changing environment. The trick for executives will be using this information to adjust as history unfolds around them.

Harold Macmillan, British Prime Minister from 1957 to 1963, when asked what might blow his government off course, supposedly replied, “Events, dear boy, events.” Companies will have to learn to adjust to surprising political events in order to prosper in an uncertain world.



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# Geopolitics in clean tech

By Marco Tavolieri

**The latest developments in Europe’s clean technology sector show how investors can be subject to significant political and regulatory risks even within developed countries such as Spain, the Czech Republic, and Italy. Where these risks are present, fraud is often not far behind.**

In order to reach the European Union’s (EU) target of obtaining 20% of energy from renewable sources by 2020, member countries had guaranteed favorable feed-in tariffs to investors in the renewable energy sector for periods of 10 to 20 years. The sovereign debt crisis, however, as well as technological improvements that have decreased the cost of equipment such as solar panels, have pushed some EU countries to

decrease the level of these feed-in tariffs. Certain jurisdictions made major amendments to existing regulations retroactively with devastating effects on investor confidence. In the photovoltaic sector in Spain and the Czech Republic, for example, recent tariff changes have affected some plants that are already in operation; it comes as no surprise that this has led to a substantial decline in investment. In March of this year Italy too

issued an unexpected new legislative decree on tariffs in the renewable energy sector, leading to concern and uncertainty among investors, contractors and developers.

Meanwhile, local regulatory frameworks can also create significant risks for investors. In Italy, risk arises from lengthy and bureaucratic regulatory and authorization procedures, as well as from divergent clean technology policies at the national, regional, and local levels. These all create delays in obtaining licenses and putting plants into operation. This has led in the south of the country, where solar and wind plants are concentrated, to the rise of intermediaries who claim to be able to obtain all the necessary authorizations for investors and to sell them what are essentially turnkey projects. Clearly, this heightens the risk to investors of becoming involved in corruption or even of infiltration by organized crime.

Several factors make the renewable energy sector particularly attractive to organized crime in Italy, including: advantageous feed-in tariffs; the central role of potentially corruptible local politicians; the opportunities for laundering money; the trading of plots of land; and the opportunity to use illegal workers. In Sicily, Calabria, Apulia, and other regions, a number of investigations – such as the “Via col vento” and “Eolo” inquiries – have led to the arrest of entrepreneurs, developers, city mayors, and public officials on charges of corruption and often of criminal association. Many domestic and foreign investors who had dealings with such dubious counterparties subsequently had their authorization applications delayed or blocked, or even had plants already in operation seized. Moreover, they saw their names in Italian and international media reports alongside those of figures allegedly connected to the Mafia, causing serious embarrassment and reputational damage.

As the Italian example shows, political risk and fraud often go hand in hand. Investors need to be as aware of these twin dangers in Europe as anywhere else in the world.



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# The complexities of compliance in India



By Richard Dailly

**As the breadth and depth of the globalized economy expands, multinational corporations and investors find themselves assessing new opportunities in unfamiliar regions. International business norms suffused in the legal practices of the West, where they largely evolved, are increasingly coming into conflict with how business has traditionally been conducted in developing parts of the world.**

First consider how India got to where it is: the sub-continent was unified in the third century BC and over the next 1,500 years created one of the world's most advanced societies. Islam arrived from the West, leading to the establishment of the Mughal Empire alongside the Hindu Maratha and Rajput Empires. Thousands of years of interplay and overlap between competing Asian cultures and religions, followed by colonization by the British, created a multifaceted society which varies dramatically from region to region.

## Some notable risks

A particular legacy of the British Raj is the all-pervasive nature of bureaucracy. Some local laws might seem archaic to outsiders and locals alike: the need, for instance, for companies to keep a book of attendance. The truth is that these mechanisms can allow poorly paid officials to ask for under the table payments. Unwittingly, businesspeople can find themselves open to requests for bribery.

In the same way but on a larger scale; the size of India's bureaucracy has created an army of retirees, many of whom become consultants or join the boards of companies as independent directors. While these individuals are able to open doors and facilitate introductions, their use requires extreme caution. It is not uncommon for a former official to be seen as a breadwinner among a team of current civil servants. "Commissions" paid by a company to a former official-turned-consultant are often no more than bribes.

Cash payments in order to make things happen, to both officials and non-officials, are normal; in many sectors it is not seen as unethical and simply seen as a price attached to doing business. Firms committed to high standards of corporate integrity need to think seriously about how these issues could affect them.

India's democracy is often well intentioned toward the poor. The combination of a politically enfranchised lower class and poverty, however, can produce unintended results, such as the predominance of single-issue politicians. Occasionally, these individuals wield inordinate amounts of power in local coalitions. For example, a representative elected by slum dwellers might see as a threat infrastructure development which could lead to the re-housing, and therefore loss, of his constituents. It could be in his interests to oppose redevelopment unless other incentives – notably bribes – come into play. Similarly, land acquisition is a contentious and opaque issue in India, rife with corruption. Any major infrastructure project will almost certainly encounter problems – from the unethical removal of local residents to insider dealing on the value of land – which can have clear and serious compliance consequences.

Mining and power generation companies looking to invest in India's central eastern states will face the added difficulty of working in areas which are subject to a Maoist insurgency. These groups, professing an agrarian communist ideology, could be seen to present a sovereign threat to the national government. They have

boycotted the democratic process and admit to leading an "armed struggle" in states which rank among India's poorest. Investors may be pressured to pay these insurgents to operate in the area and, if a bribe is not forthcoming, the rebels might use their influence to disrupt a company's operations. It may be tempting to capitulate, but investors need to be aware that this would be a high-risk strategy, potentially exposing them to India's terrorist financing laws. Many Maoist groups are proscribed under Indian anti-terrorism legislation and so payments to them could constitute a serious offense.

Kroll has learned through numerous investigations in challenging parts of India that these risks often overlap and interact with one another, though how this happens is unique to every location.

A company, for example, might experience hostile pressure from the media and labor unions. Further investigation may then reveal that these critics are being manipulated by a local official attempting to use his influence for personal gain – blackmail, essentially. If the business agrees to pay the official, the hostility will cease. The official may even justify his actions by saying that the money will be partially fed back to the community or aid development and alleviate poverty in the region, thereby increasing his political influence. Bowing to extortion of this nature will leave a foreign company exposed to breaching business compliance and governance laws, not just in India but potentially in its home country. It also gives the corrupt official and his accomplices the "green light" to continue extorting in such a way.

## Mitigating the risks

When operating in such a complex culture, a sophisticated understanding of the local area is essential. For example, in cases such as the corrupt local official above, in Kroll's experience companies usually have more leverage than they realize. A sophisticated analysis of wealth, demographics, movement of people, and other societal factors can add significantly to a company or investor's understanding of the environment in which they are operating. A thorough understanding, for instance, that the population of an area is diminishing through economic emigration, leading to a lessening of support for a corrupt local official, could influence an investor's decisions. Meanwhile, meaningful investment into poor areas could

reduce such emigration and give the company a real voice in the local society. Maintaining a culture of anti-corruption might initially seem impossible, but if a local official's vote bank is dependent on jobs in the community, then the threat of pulling out would turn popular opinion against the bribe-seeking politician.

A culture of anti-corruption is essential from a legal and compliance point of view, but simply ignoring the problem is unlikely to be an effective strategy. Knowledge of the local community should lead to broad engagement with it in which researchers, analysts, trusted community liaison staff, corporate communications, and CSR professionals work seamlessly.

Kroll suggests that elements of this strategy might include the following:

- Commission independent consultants to provide an in-depth analysis of the geography, local culture, and historic issues in the region;
- Make contact with the media, academics, environmental groups, local officials, unions, lobbyists, NGOs, and others in order to better understand the fault lines;
- Consider recruiting a well vetted local liaison officer;
- Make tough policies on compliance and governance well-known in the local community. This might include a well publicized policy of non-payment of commissions, whistleblower hotlines, well advertised compliance and anti-corruption policies, even "open door" policies, to nurture a culture of transparency and accountability
- Consider meaningful contributions to the local community, not a "name-only" CSR program;
- Consider ways of using the local community in the operation, making them stakeholders.

Entering a new, unfamiliar culture does not mean a company has to compromise its governance standards but it does need to learn how best to maintain them in these unfamiliar conditions.



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# Infrastructure and waste in Brazil:

## Two lucrative but challenging investments



By Vander Giordano and Eduardo Gomide

**In November 2009, The Economist noted that “Brazil has been democratic before, it has had economic growth before and it has had low inflation before. But it has never before sustained all three at the same time. If current trends hold (which is a big if), Brazil, with a population of 192 million and growing fast, could be one of the world’s five biggest economies by the middle of this century, along with China, America, India and Japan.”**

Brazilians as well, in recent years, have begun to call the country “*a bola da vez*” – the cue ball. The media has reported extensively on how Brazil is finally tapping into opportunities in a changing world economy and fulfilling all the potential of its large population, fertile lands, vast mineral resources, and now huge deepwater oil reserves discovered in the last decade.

However, economic growth and prosperity – Brazil’s GDP rose roughly 7% in 2010 – also bring the risks associated with excessive optimism and a gold-rush mentality. On top of the “big ifs” listed above, investors and companies need to pay careful attention to details when it comes to where they put their money. A consideration of just two areas – the potential pitfalls of Brazil’s rapidly growing infrastructure sector and compliance issues

arising from new environmental legislation – show that a lack of such care can be costly.

### Playing the game cleanly

Brazil is about to host two major international sporting events. In 2014, the World Cup will be played in Rio de Janeiro and 12 other leading cities. Two years later, Rio will welcome the Olympic Games. Analysts are predicting an enormous impact on the economy, with infrastructure investment as the driving force. A study by Brazil’s Sports Ministry estimates the potential economic impact from the World Cup alone to be near \$100 billion between 2010 and 2014, of which 73% will be indirect – and cites an expected \$5.13 billion in incremental tourism, \$9.18 billion in tax collection and the creation of 330,000 permanent jobs<sup>1</sup>.

The vast opportunities related to the rebuilding and expansion of Brazilian infrastructure are attracting foreign investors. Some estimates put the likely cost of the planning and construction of Olympic sports venues alone at \$15 billion. The costs of rehabilitation or building of stadia for the World Cup, along with improvements in ports, upgrading of public transport and roads, and the expansion of airports necessary for both events will involve at least another \$18 billion. These figures may even be underestimates.

Taking part in the infrastructure boom in Brazil will almost always involve a public bid. The major infrastructure projects, such as hydroelectric plants and enhanced power grids, as well as new ports, highways, and airports are largely backed by agencies with full or partial government ownership, including the Brazilian Development Bank. The second phase of the national Growth Acceleration Program (PAC), the largest public sector investment program of the past 20 years, will open up US\$220.2 billion in opportunities for foreign investment in Brazil over the period 2011 to 2014. The State has also established the Olympic Public Authority to coordinate the works for the Olympic and Paralympic Games. Companies must be aware of the risk of getting caught up in bribery or corruption schemes in violation of Brazil’s own laws as well as the US Foreign Corrupt Practices Act and the UK Bribery Act.

Once such cautionary tale involves a European company which came under scrutiny by both European and Brazilian authorities in 2009. The company had subcontracted a European engineering firm for their infrastructure projects. Authorities began to suspect that a \$6.8 million expense they had on their books was, in fact, made to local public officials in order to win a \$45 million subway project in Brazil.

Further investigation revealed that this same company made close to \$200 million in suspicious payments in connection with a hydroelectric project in Brazil. The scheme allegedly involved a consultancy contract with a Panamanian company.

The consultant was hired to provide information to help in the bidding process for the hydroelectric power plant. But both Brazilian and European investigators are convinced that the Panamanian company never provided any consulting services and that their sole purpose was to act as a go-between to deliver bribes to secure the contract. Meanwhile, the European engineering company is prohibited from participating in contract bids in Brazil until the investigation concludes, effectively barred from the infrastructure boom.

## An investment gone to waste?

Brazil produces 150,000 tons of garbage annually. Its comprehensive National Policy on Solid Waste, passed into law last July, is the culmination of a long line of policies strongly emphasizing the use of recycled materials. Nevertheless, despite the efforts of the national government, states, municipalities, agencies, and industry organizations, up to 43% of waste collected in Brazil may not be adequately treated.

Compliance with the new law's regulations on business will require many companies to invest in new technology and procedures, as well as spend considerable amounts on monitoring and auditing activity. For investors in the country, meanwhile, due diligence should now go beyond assessing the background, reputation and integrity of a business to include compliance with the new waste management regulations. Otherwise, buyers risk inheriting liabilities that might eventually jeopardize their entire investment.

Recently a foreign group acquired a Brazilian petrochemical company. Eight months later, the firm's legal department received a subpoena from the State District Attorney.

## TOP FRAUD RISKS

Buyer beware. Maybe the local partner appears to be the right one with the right connections. But a closer look can often reveal problems. If a foreign investor doesn't do their homework, they could wind up with:

### Unqualified partners

- Check out reputation and integrity history – carry out extensive analysis of your partner's past contracts and legal history, especially involving the government and state controlled agencies.
- Know your suppliers – in the waste treatment case, the company chosen to treat the waste had neither the credentials nor the organizational structure necessary to meet the contractor's disposal needs. A check of the supplier's background and history, searching for references or perhaps even some on-the-ground investigation could have reduced the risk exposure.

### Regulatory and compliance breaches

- Pay attention to compliance. Foreign companies need appropriate advisors who understand local laws and regulations and can help make sure compliance structures are in place. The consequences of non-compliance can be great, as with the example of the European engineering company who cannot enter into any new business until their Brazilian legal process is concluded.

- Look into the complex Brazilian labor regulations and find out how your business partners are dealing with it, including its subcontractors. In a joint venture, every member is responsible for the fulfillment of all legal labor obligations arising from that contractual relationship. A group of investors in a São Paulo construction company learned that the hard way. Much to their surprise, a few months after completing their transaction, they were informed at a board meeting that the construction company was now liable for labor claims filed against a subcontractor who had worked on one of the company's projects in northern Brazil. Because the subcontractor was unable to meet those claims, the responsibility was now theirs.

### Corruption and bribery risk

- Watch out for conflicting business relationships through shareholders or contractors. And consider some background checking on key employees. In the waste management case highlighted, there were discrepancies in the company's records. Much was due to the fact that one of the employees responsible for the process – the weigh scale operator – was receiving kickbacks from the waste collection company, who received more resources for a lower actual amount of garbage removed.

The company, along with others which outsourced waste management to a particular garbage treatment and disposal business, was being included in a civil action. The waste treatment company was not compliant with the new law in some of its processes: waste, for example, was being discarded without treatment. This left the petrochemical company also in violation of the law and subject to heavy fines.

Kroll was hired to investigate the matter and found that the risk could have been managed during the due diligence process had the auditors at the time done a more thorough review and spent more time looking at the waste disposal company's record. Evidence already existed about its failings as did complaints about operational activities. Kroll's evaluation of waste disposal documentation also found large discrepancies in weight and outright falsifications. In some cases, the waste management truck did not even enter company premises, although the contractor had a record of trash removal. Similarly, field interviews indicated that some of the waste was simply thrown in the city's public dump.

Kroll's reports supported efforts by the foreign acquirer's lawyers to prove that the new shareholders of the petrochemical company had acted in good faith. The responsibility for the violations of the waste law was therefore assigned to the former owners.

Brazil's economy provides substantial opportunities for foreign investors. To fully profit from them, however, companies need to learn about the risks.

1. Global Finance Magazine, September 2010



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# Investing in Mongolia

## Opportunities and risks in the newest hot market



By Jack Clode

Mongolia is an enticing investment location. In 2010, its economy was the world's second-fastest growing<sup>1</sup>, and it is expected to be among the top three in 2011. Its equity market is acting accordingly, with the Mongolia Stock Exchange Top 20 Index more than doubling in 2010, and has again doubled since the start of this year

Mongolia's primary driver of growth, the mining sector, is attracting substantial foreign investment. Companies from North America, Russia, China, and elsewhere are developing significant and profitable operations out of the country's massive deposits of coal, gold, copper, rare earths, and other minerals. Private equity funds, commodity traders, and other investors are also rushing to the country in search of the right opportunities.

Policy and regulatory changes that have opened up Mongolia to foreign investors and businesses have helped bring about its rapid growth. Now, however, the government faces serious challenges, such as creating a mature, transparent, and stable regulatory environment and establishing controls and enforcement mechanisms to minimize corruption.

The country is gradually strengthening and empowering its control institutions. In 2006, for example, the government passed an anti-corruption law and formed a specialized Anti-Corruption Agency.

Nevertheless, efforts to create the necessary environment remain far from complete. The application of laws and regulations is unpredictable. In November 2010, the government surprised the international community by suddenly suspending 254 gold mining licenses, citing a 2009 law which protects Mongolia's forests and river basins. Some international companies have appealed and had their licenses reinstated; others have not yet been successful. These types of incidents damage investor confidence and are not limited to the mining industry. More than one large hotel project in Ulan Bator has been suspended because of disputes over the interpretation of real estate regulations.

Moreover, lines between the public and private sector remain blurry, with conflicts of interest being common. Complicating matters further, investigators in Mongolia cannot rely on the official public record to identify ownership and control of locally-registered businesses. Instead, Kroll uses human source inquiries and knowledge about Mongolia's elite to understand who actually controls a company. Sometimes these inquiries lead to prominent political families, at which point risks arising from the United States Foreign Corrupt Practices Act need to be thoroughly evaluated as well. It is also common to find that company control is quietly exercised by powerful, sometimes controversial, individuals from Mongolia's neighbors, Russia and China.

Information on Mongolian individuals is also hard to obtain, making it difficult for foreign companies to understand the track record, reputation, and liabilities of potential business partners. Currently, litigation, bankruptcy, or criminal record databases do not exist, and Mongolian news research is a tool of limited value. Many domestic news outlets are quietly controlled by politicians who inevitably have a particular agenda. Allegations of corruption against businesspeople or politicians often appear in print with no further mention anywhere in the public record. Those interested have to dig deeper in order to determine which allegations of corruption are grounded in fact and whether any such claims in the press resulted in legal sanctions.

Due diligence in such an environment is exciting work. Interesting intelligence often comes to light which help our clients negotiate the restructuring of financial terms or management structure, and sometimes leads to an exit from the proposed transaction. Such research is essential in a rapidly growing, imperfectly regulated economy, and because the country is small, with a powerful business and political elite, we frequently see the same names reappearing in our investigations. Our extensive experience and deep expertise in Mongolia therefore helps us to advise our clients quickly on a deal's prospects.

1. Eurasia Capital: Mongolia Outlook 2011



**Jack Clode** is a managing director in Kroll's Business Intelligence & Investigations division in Hong Kong. With over 12 years at Kroll as a front line investigator, case manager and office head, Jack supports clients across the broad range of Kroll's services, including due diligence, business intelligence, competitive intelligence, security, internal investigations and external investigations.

# Private equity and the Foreign Corrupt Practices Act

By Peter J. Turecek and Michael E. Varnum

**More private equity firms are investing internationally. In doing so, they are encountering a regulatory environment shaped by increasingly aggressive enforcement of the United States Foreign Corrupt Practices Act. In particular, regulators at the Department of Justice and the Securities and Exchange Commission have beefed up their investigative teams and are now looking more carefully at majority investors in entities alleged to have violated the law.**

While no private equity (PE) firm has to date been charged for Foreign Corrupt Practices Act (FCPA) violations by a foreign portfolio company, the threat is real. Exposure to penalties arising from such violations depend on, among other things, the level of management and oversight provided by the PE firm. The greater its involvement in the portfolio business, the deeper regulators will probably look up the ownership structure in assessing culpability. Simple ignorance will not serve as an adequate defense. PE companies that are currently active or expanding abroad therefore need to enhance, or where necessary establish, effective compliance and due diligence procedures.

The difficulty facing PE firms and other investment vehicles is that the nature and extent of “appropriate” due diligence are not clearly defined by regulators. At a minimum, both PE firms and their portfolio businesses should have well-documented internal FCPA compliance policies as well as evidence of an appropriate level of due diligence investigation for transactions. This level will vary by jurisdiction, with locales known for corruption requiring enhanced due diligence measures before entering deals or engaging agents. Private equity companies also need to ensure that these FCPA policies are rigorously followed. This begins with a clear message from the

top that corruption and related practices will not be tolerated, either at the parent company or within portfolio businesses. Appointing a compliance officer, creating a thorough set of policies and procedures for employees and agents, and conducting regular staff training and audits reinforce an appropriate tone to guide the firm’s behavior. These steps should support a corporate ethic rather than force an aversion to risk. It is important to understand that regulators will look for documentation of these policies and consistent adherence to them, should an FCPA issue be identified.

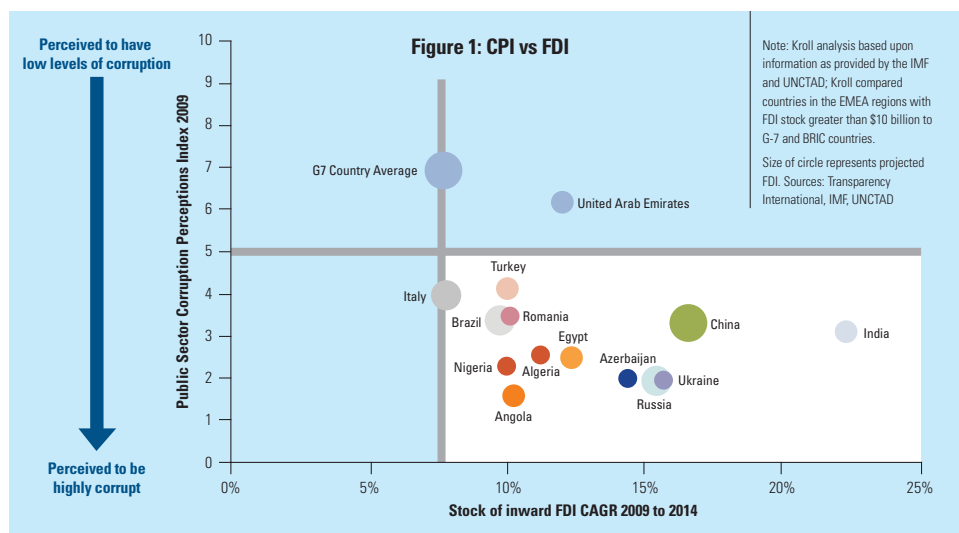
Before entering a transaction, PE firms need to undertake appropriate due diligence, which includes looking at all local third party participants, agents, representatives, consultants, and joint venture partners. Are the agents exclusive? What connections, if any, exist with the local government or state-sponsored agencies? Who are the beneficiaries of the joint venture partners? An inability to answer these questions may indicate that the PE firm or portfolio company doesn’t sufficiently understand the relationships of their business partners and activities, leaving them vulnerable to potential FCPA violations and regulatory attention. While it is often impossible to investigate every thread to its conclusion, a consistent, documented

methodology of due diligence can help avoid surprises later in the investment lifecycle.

As investment discussions continue, any evidence or rumor of suspicious behavior or governmental contacts should be thoroughly investigated. These are the situations in which enhanced due diligence or actual investigative efforts may help provide deeper factual understanding or context around a rumor or evidence of behavior. The PE firm and portfolio companies should review all of the deal-related documentation available for accuracy, detail and adherence to standard internal codes of conduct and accounting procedures, including sufficient record of gifts, contributions, reimbursements, travel and entertainment.

The Department of Justice (DOJ) has demonstrated leniency in some FCPA cases because of mitigating factors, including self-reporting, past and continuing cooperation with the investigation, implementation of remedial measures (including an FCPA compliance program), and the absence of prior similar conduct. However, the failure to carry out adequate due diligence can have a devastating impact. Consider eLandia International, which acquired Latin Node in 2007 only to learn afterwards of potential FCPA violations. The company self-reported to the appropriate authorities, but the ensuing investigation, fines, penalties, and termination of employees decreased the value of the purchase by over \$20 million, according to reports at the time. Eventually, eLandia wrote off the entire business.

Self-reporting to regulators – after receiving appropriate legal counsel – is nevertheless usually the best policy for PE firms that identify possible FCPA violations, either in the course of acquisition due diligence or in a portfolio company’s ongoing operations. To receive the benefit of such action, though, companies need to have policies and procedures in place and adhere to them. Failure to do so could prove disastrous.



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# Remember to breathe

## Compliance and the United Kingdom Bribery Act

By Melvin Glapion

**“Remember to breathe” is good advice for someone experiencing acute stress. It is, in essence, what I am telling many clients in anticipation of the UK Bribery Act. Admittedly, though, this is hard to do when, at every seminar they attend, the speakers serve fear with canapés.**

Some of the bribery law’s unique provisions certainly should give businesses pause, in particular: i) strict corporate liability for failing to prevent bribery, whether by employees or third parties; ii) disallowance of facilitation payments; and iii) extra-jurisdictional enforcement. Most large or medium-sized companies, though, already have the infrastructure, policies, and procedures to meet this compliance challenge. Despite the stringency, the United States Foreign Corrupt Practices Act (FCPA) has made us better equipped to recognize, prevent, investigate, and report incidences of corruption.

The change in corporate liability and increased exposure to third party activity has sparked panic among businesses. In order to achieve Bribery Act compliance, some

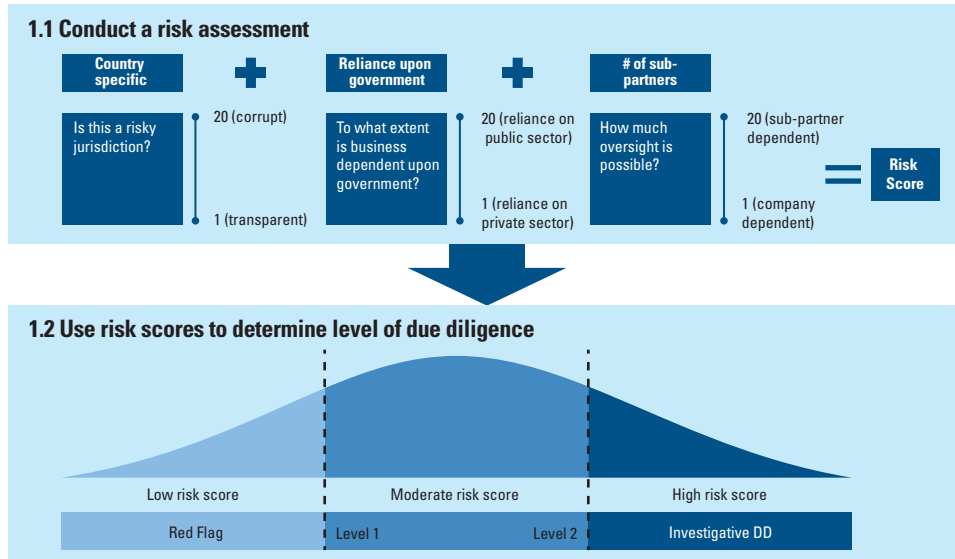
organizations are now thoroughly investigating, on an annual basis, every current and prospective associated third party vendor, agent, or supplier – a prohibitively expensive and logistically arduous practice which is neither practical, economic nor commercially-savvy.

Businesses will benefit by taking a structured and considered approach to conducting reputational due diligence which takes into account the conditions that exist in the real world. As described below, a company should: prioritize due diligence on third parties; establish a process for third-party compliance with anti-corruption policies; manage the costs of diligence; and use the findings to gain competitive advantage. Take a deep breath and let’s begin.

## Prioritizing investigations into third parties

Clients seeking help with prioritizing their due diligence efforts often ask three things: where to start, to which third parties to give most attention and how often to screen them.

The best tool for answering these questions is a risk scoring system that compares a population of firms, (for example, distributors) using markers of potential corruption risk (Figure 1.1).



These markers might include: the Transparency International Corruption Perception Index score for the jurisdiction where the distributor conducts most of its activities; the degree to which it relies on government contracts or relationships for its business; the extent to which it has knowledge, control, or oversight of the distributor; the length of the relationship between the firm and the distributor; its corporate ownership structure; or the scale of its business. Select the three or four markers most appropriate for the group of companies being ranked and then establish a grading scale to determine the appropriate level of due diligence required in each case. Hence, a distributor operating in Mumbai with several agents and over half of its sales to private sector clients will be more thoroughly investigated than one based in Manchester with no agents and revenues derived entirely from the private sector.

## Balancing the costs of due diligence with the need for compliance

For large and medium-sized firms, with hundreds, sometimes thousands, of third parties, the cost of due diligence very quickly becomes prohibitive unless a risk-based approach is taken.

The best way to manage this dilemma is by using the results of the risk assessment to form a risk matrix profile (Figure 1.2). The matrix addresses two assumptions of the dilemma:

- All companies should be screened pragmatically – this approach fails to go deep enough in assessing riskier companies.
- Screen everyone at the highest level – again, an inflexible approach which is cost prohibitive and potentially disruptive to operations.

through a secure, online platform. Information collected from partners typically includes affirmation to our client's code of conduct, answers to a risk-related questionnaire pertaining to business history and controls and backgrounds of key management, as well as commercial references. A client dashboard allows clients to sort third party data by many risk factors, including their risk score, geography, industry type, and other emerging threats, to help determine the appropriate level of due diligence in each case. The platform also enables clients to create a structured, consistent and auditable repository of client data.

## Using compliance as a competitive advantage

Compliance activity is not typically considered a key source of competitive advantage. However, we have seen several due diligence investigations where the information gathered has helped clients create or improve business relationships, for example:

- to secure an exclusive arrangement with an agent in an important growth market after research showed that other agents in the region had serious reputational issues;
- to obtain better terms from a distributor to account for its moderately higher risk profile;
- to press for changes in the ownership structure or management team at a potential distributor; and
- to gain greater insight or control over a partner's code of ethics, communications, and reporting policies.

The Bribery Act is here to stay and businesses need to adjust accordingly to its place in corporate life. This shouldn't mean banning corporate hospitality or halting all operations in far-flung territories, but there are compliance expectations to be met. While most are in a good position, using a risk matrix, matching diligence to actual risks, and employing information from diligence research as a competitive tool is the best way to implement a compliance structure that is both effective and economical. Now exhale.

If most medium-sized or large companies were to display the results of their risk scorings in a distribution, they would resemble the bell curve. Somewhere between 10-15% of third parties would fall into the relative low risk category; the vast majority, 70-80%, into the moderate risk category; and the final 10-15% would be high risk.

While the eventual costs to the firm remain significant when using a risk-based system, it matches the level of due diligence to the perceived risks of each third party. This enables companies to better balance best practices in compliance while managing costs to the bottom line.

## Implementing a reasonable & proportionate response

As outlined above, the majority of large and medium-sized companies have invested in developing sophisticated anti-corruption policies but the challenge is to get third-party contractors, suppliers and distributors to comply with such policies in a consistent and auditable manner. Kroll has developed a new, on-line third party screening program, which enables clients to acquire and manage data about their vendors, agents and suppliers



**Melvin Glapion** leads Kroll's business intelligence practice in London. He has over 16 years of experience of M&A, corporate strategy and financial analysis experience, leading multi-disciplinary and multi-jurisdictional teams in conducting cross-border market entry, due diligence and competitive intelligence engagements. Previously he advised on corporate strategy initiatives at KPMG, and has held several other strategy roles within the private sector.

# Resolving commercial disputes in China

## A Case Study

By Violet Ho

**“Business in China is booming and we have a well-connected manager who has secured recurring large government contracts. We don’t know much about these customers because he’s dealing with them through an intermediary – apparently that’s the way things are done there. He’s been faithful for years, so we trust him, and anyway we can take over the business any time we want.”**

Such sentiments may look suspicious in writing, but things can feel different when the dollars are rolling in and there is no time for questions. Executives at Kroll client CliCo Ltd – a pseudonym for a well-known US listed company – know this only too well. Its operations in China started out as a joint venture. After restrictions on foreign investment were eased, CliCo converted the business to a wholly foreign-owned enterprise by acquiring the shares previously held by its Chinese partner.

Everyone was happy until a large account receivable began building up with a key customer about whom CliCo corporate headquarters had no identifying information. Unsatisfied with the local CEO’s response CliCo, without seeking legal advice, sent in an audit team while the CEO was away on a business trip. Word reached him via loyal local employees, and he angrily demanded that CliCo remove the team. The company complied, but its relationship with the errant CEO deteriorated further. Finally, after the account receivable had significantly increased, CliCo engaged external legal advice and started considering removing the CEO, who by now had cut off communications entirely.

### How to address suspicions

A panicked reaction to a potential problem can damage the chances of a smooth resolution. When red flags go up or a whistleblower makes an allegation, a company may contact the accused wrongdoer too soon. If the allegations are true, this could give the culprit time to destroy evidence and settle on a story with his accomplices before an investigation starts. Reacting to a false allegation, on the other hand, can demoralize a company’s workforce, create mistrust, and damage its reputation.

If suspicions are raised, remain practical and plan ahead. Decide whether you want to investigate the merit of an allegation, find out what damage has been done, or gather evidence to identify the source of the wrongdoing. Also, consider if your objective is court action, termination of the CEO – dismissal of an employee in China for cause requires proof of wrongdoing – or an exit from the relationship.

The element of surprise is vital, particularly in the early stages of an investigation, so maintain a close-knit team and work out who can be trusted. Most important, a company should engage external expert support early. Too often clients do not contact Kroll until after they have attempted to investigate the problem themselves, not realizing that any fraudulent

activity that they discover is usually just the tip of the iceberg. Amateur efforts may even make the investigation more difficult. Searching emails in the wrong way, for example, can destroy or compromise vital evidence.

In CliCo’s case, getting information was difficult but what eventually came to light was startling. The local CEO had been using CliCo’s money to operate a string of other businesses during his tenure. There were fraud and embezzlement issues as well as potential exposure to the United States Foreign Corrupt Practices Act arising out of transactions with Chinese government agencies.

### Chop and change

The above advice is relevant in many parts of the world, but Chinese law creates some particular nuances in such cases. Once a company has gathered enough evidence to prove wrongdoing, the next step maybe to terminate the CEO and take over the operation. Like in the case of CliCo, the company wrongly assumed that 100% equity control gave it full management control. In Kroll’s experience, this misconception is one of the most common causes of disputes in China. In order to resolve an issue like this one, two things are needed: control of the company chop, an instrument



used to put an official mark on company documents; and the approval of the legal representative, the person legally authorized to enter into transactions on behalf of the company.

In CliCo's case, the local CEO refused to return the company chop and threatened to report the company's behavior to the government. CliCo would then face a real risk of losing its business license altogether. At the client's request, Kroll carried out in-depth personal profiling of the CEO and his government supporters as part of making a threat assessment. A forensic accounting exercise uncovered records of deals which were done with the CEO's handshake as well as evidence of records that had been altered. Kroll also looked closely at emails to work out who was who within the fraud scheme and to identify the external parties and what they knew. Working with external legal counsel, Kroll put together an exit strategy involving plans for negotiations and possible arbitration in relation to the termination and prosecution of the CEO. The investigation went on for months. CliCo successfully got rid of the CEO but he walked away with a significant sum of money.

The errant CEO's close relationships with local officials, which had once seemed such a

positive thing, actually made CliCo's situation more difficult when they tried to remove him. He also had the backing of the workers' union, and CliCo faced a group walkout from local employees when it attempted to remove him. This highlights that there is never a vacuum in a company: if someone does something wrong, someone else will always know or play a part in it. On the other hand, not all employees are corrupt. For both these reasons, post-termination internal communication is invaluable. This will help transfer loyalty from the former ringleader back to the company and promote a zero-tolerance attitude to fraud.

### Stop a problem before it starts

Companies like CliCo can avoid such a dispute, or at least reduce the risk of it happening, by putting in place some key measures:

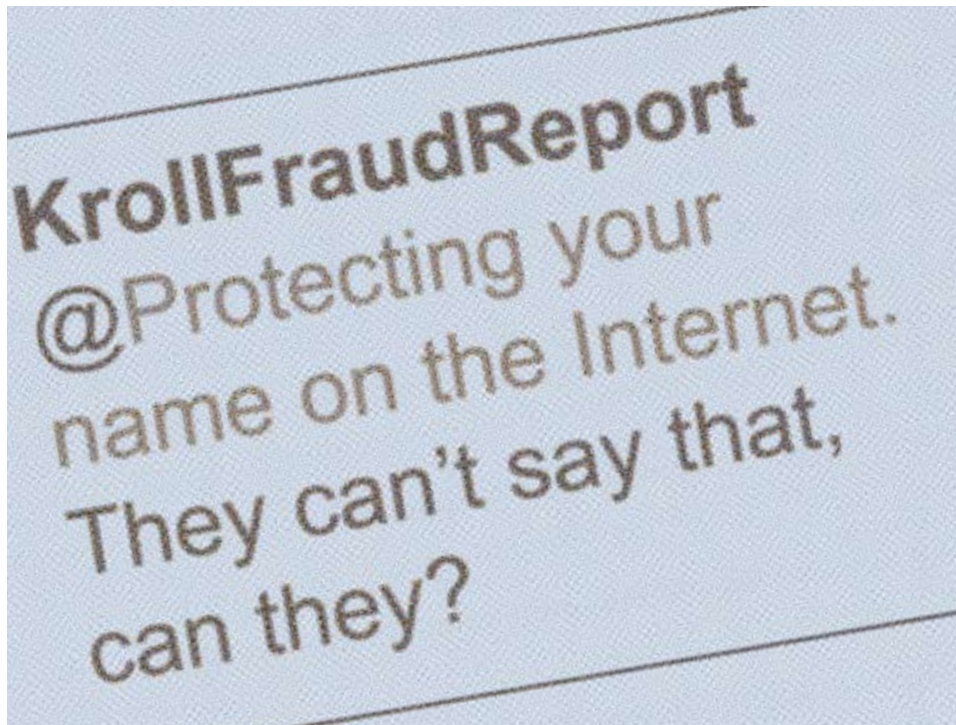
- Hire trusted people. This requires thorough due diligence on a range of matters including whether the candidate has been in disputes before with foreign or local partners;
- Visit your sites in China rather than relying on a quarterly report from your subsidiary;
- Create checks and balances so that power does not become concentrated in one or a few people;

- Build and maintain your own relationships with government regulators;
- Do not place all your confidence in equity control, which does not equate exactly to operational control; and
- Make sure you have a policy on the control of the local company chop, and maintain a paper trail to avoid fictitious contracts which have to be honored.

In our case study, CliCo's usual caution had been overwhelmed by the kind of gold-rush mentality commonly seen in developing markets. The company needed a Chinese partner and saw no reason to find anything amiss with him. It was unfortunate for CliCo that his opportunity to commit fraud arose after it injected cash to change the subsidiary's structure. China is a great place to do business, but always be careful, call on outside help as early as possible, and remember that it is never too late to start your due diligence.



**Violet Ho** is a managing director and head of Kroll's operations in China. Violet has managed a wide range of risk consulting projects in Greater China ranging from fraud prevention to investigations of white-collar crime and distribution scams. She also manages investigative due diligence inquiries and assignments on business controls, intellectual property protection, employee risks, corporate security and crisis management.



By Mark Skertic

**The Internet is the largest public forum ever created, a virtual arena for the conduct of commerce and the exchange of information and ideas. As companies have learned, though, it is also a place where hidden foes can carry out virulent attacks.**

A few years ago, Internet crime often meant a company's website was vandalized, taken over by hackers and defaced with virtual graffiti. Companies had to guard against phishing attacks or they contended with devastating viruses delivered via email attachment. These threats still exist, but many more have joined them: angry former employees creating hostile web pages, sometimes embellishing facts or outright lying for maximum effect; short sellers blogging and tweeting about a company's perceived problems, hoping to drive down the stock price; or critics launching potentially libelous assaults on YouTube or in social media forums.

There is no single set of rules governing how to respond to such crimes. More than 90 countries have adopted laws ensuring the public's access to information, but there are also restrictions on that openness, part of an effort to balance Internet freedom with

interests such as protecting trademarks or proprietary works. Who polices what appears on a website? In 2010 the Danish Supreme Court, for example, upheld a lower court decision which requires Internet service providers (ISPs) to block access to any websites that contain – or link to – other sites that infringe on copyrights. In the United Kingdom and other countries, citizens can petition ISPs to remove material that violates the law.

In the United States, the Digital Millennium Copyright Act protects an ISP from a third party's copyright infringement as long as the ISP has no knowledge the work is protected. Once the copyright holder notifies the ISP, the material has to be removed and the website user who posted it notified. Then a back and forth commences, with the website user given an opportunity to assert a good faith belief that the material is not protected.

Fast food chain Domino's Pizza faced a public relations nightmare when two employees at a franchise videotaped themselves intentionally conducting unsanitary acts while preparing food. The videotape was posted to the free site YouTube, which led to their firing and arrest. The Domino's franchise owner used the Digital Millennium Copyright Act to have the offending video removed. The company did have another use for YouTube. It used the website to post an apology to customers from its chief executive officer.

Some attacks are more sophisticated and can be harder to address. In 2010, BP was assailed online over its handling of the spill

in the Gulf of Mexico. In addition to campaigns against the company on blogs and Facebook, the company had to contend with messages sent from a fake Twitter account, the seemingly real sounding BPGlobalPR. At one point, the phony public relations Twitter account had more followers than the company's actual Twitter account. The challenge for BP became responding to a multi-pronged Internet attack. There was no single ISP or website to address the multitude of attacks.

At times, even responding can backfire. Attempting to suppress material on the Internet can result in it being exposed to a wider audience. This irony has become known as the "Streisand effect," named for the singer-songwriter Barbra Streisand. In 2003, an environmentalist posted photos of Streisand's Malibu, California beach home on the Internet. She went to court in an effort to have the photos removed, but the publicity her lawsuit generated brought more than a million people to the website to look at the photos of her home. Businesses understand that by trying to take down a site that illegally targets them they may inadvertently draw attention to a critic's blog or Facebook posts, boosting the detractor's audience, and further hurting the company's reputation, undermining consumer confidence and making it an even bigger target for such attacks.

Often, an investigation can determine who the anonymous individual is behind a blog without involving authorities or filing a lawsuit. In 2010, the owner of a small firm in the Midwest was the subject of attacks on a blog about his industry. Most troubling to the business owner was indications the blogger had access to insider information about the company. A discreet investigation used Internet website registration information, the blogger's email and information posted on other websites, including a Facebook page, to determine the blogger had ties to someone whom the business firm owner has been in litigation with.

In this instance, the firm owner was able to use this information to inform the blogger that the attacks needed to cease before litigation began. The incident never ended up in court or in newspapers, and the problem was resolved.



**Mark Skertic** is a director in Kroll's Chicago office. A former journalist, he covered the airline industry and financial markets for the Chicago Tribune and was an investigative reporter at the Chicago Sun-Times.



# Emerging regulatory risks in the United States

By Marcia Beross, David A. Holley, and Lisa Silverman

The regulatory fallout from the financial crisis continues across the economy. The underfunding of state and municipal pension funds is sparking new regulatory attention for both the funds themselves and the financial service companies which service them. At the same time, the whistleblower and proxy access provisions of the 2010 Dodd-Frank Wall Street Reform Act, for example, will present long-term challenges for corporate compliance and governance. This article reviews some of the emerging regulatory risks that companies need to address.

## **Underfunded pension liabilities: Everybody's dirty, not so little, secret**

The \$2.8 trillion municipal securities market is under fire for allegations of misconduct and systematic underfunding of public pensions. In 2008, the Securities and Exchange Commission (SEC) warned these funds to pay greater attention to their responsibilities under federal securities laws and last year formed the Municipal Securities and Public Pension

Unit. The increased scrutiny of law enforcement and regulatory agencies in this area will directly affect the financial services industry.

Some economists are estimating that public pension funding shortfalls could be as much as \$1.5 trillion, when adjusted for future pension liabilities. In August 2010, the SEC charged the state of New Jersey with civil fraud because it had "misrepresented and failed to disclose material information regarding its underfunding of" its two largest pension

funds. The state immediately settled with the SEC, signing a consent decree in which it neither admitted nor denied wrongdoing and paying no monetary fine. In January of this year, reports surfaced that both Illinois and California were being investigated for underfunding their pension liabilities. That same month, The New York Times claimed that states with significant per capita liability for unfunded pension benefits include Connecticut, Hawaii, Illinois, New Jersey, Kentucky, Massachusetts, Mississippi, Rhode Island, and Alaska.

Public pensions are pressuring their external providers to find innovative ways to make up the financial gap. In turn, these external advisers are shifting money to riskier investments, which have the potential for huge losses. Recent surveys show that over 70% of public pension funds have invested in derivative securities, up from only 50% a few years ago. In December 2010, Detroit's two public pensions reported losses of more than \$480 million from investments that ranged from hedge funds to vacant land in Texas and Hawaii and a Pittsburgh casino.

Adding to the potential for abuse, public pension plans are not governed by federal pension laws like corporate plans. Instead, they are overseen by boards that often include municipal labor leaders and politicians. The funds' money managers may also have split loyalties. Many handle investments for corporate pension and 401(k) plans, which can create a conflict of interest if managers feel pressure to add the stocks of their corporate clients to public pension fund portfolios.

Recently, the SEC has enacted regulations designed to curtail abuses among public money managers and Congress has introduced pension reform legislation, exposing the industry's not so little secret.

## Proxy access is coming: Will you know who your directors are?

Proxy access permits shareholders to nominate directors on a company's proxy statement; without it, shareholders wishing to nominate directors typically face an expensive proxy fight.

For a decade, businesses have opposed SEC plans to require proxy access, arguing that the commission lacked the necessary authority to do so. To remedy that, the Dodd-Frank Act explicitly empowered the SEC to issue such regulation. In July 2010, one month after Dodd-Frank became law, the commission mandated proxy access for shareholders who have owned at least 3% of company stock for three years. Each qualifying stockholder can nominate up to 25% of the board. Shareholders can also aggregate their holdings to reach the 3% level. Business groups immediately sued to block the regulations and implementation has been delayed pending a resolution of the legal issues. Most corporate governance observers, though, believe that some form of proxy access will be in place for the 2012 proxy season. It will mean a sea-change for publicly-traded companies in the United States, and lawyers recommend that they begin now to amend their by-laws.

Corporations facing proxy access nominees will have to answer a basic question: "Who are these guys?" Today, companies identify director candidates using executive recruiters, suggestions from current directors, or other sources and then conduct due diligence on them. With proxy access, a company will have just 14 days after the end of the nomination period to decide whether it will include a given nominee in its proxy statement or give reasons for exclusion. A bigger concern looms. Although current regulations forbid shareholders from using proxy access to seek a change in corporate control, any such nominees will probably be adversarial to the existing leadership. After all, if the nominating shareholders were happy with the current board, they would not nominate new directors. Current directors, for their part, fear that board elections will become like political campaigns.

Proxy access nominees will therefore warrant special scrutiny by companies. Issues to consider include:

- **Independence:** Will a proxy nominee be able to represent all shareholders given any existing ties to the nominating or other shareholders?
- **Personal issues:** Does, for example, the nominee have a history of litigation in his/her personal life that might reflect likely boardroom behavior?
- **Record:** Has the nominee been involved in prior shareholder litigation, bankruptcies, or questionable corporate governance practices? Has he or she been a dissident director on, or nominee for, other boards? Most important, has the nominee helped create long-term shareholder value? In comment letters to the SEC, the CEOs of AT&T, Dow Chemical, and IBM all cited the threat of "short-termism" by proxy access directors who may seek changes that yield a short-term rise in the stock – like special dividends – but undermine long-term investment.
- **Transparency:** Under current rules, nominating shareholders may provide a 500 word statement of support for their nominees. Does that statement include relevant details such as the above?

Supporters of proxy access argue that it has been standard practice for years in many countries and the recent financial crisis demonstrates a need for more accountability. Opponents claim that proxy access will open the board room to short-term investors and special interests. Both agree on one thing: mandating proxy access is a watershed moment for US corporate governance.

## Mitigating the adverse effects of Dodd-Frank whistleblower provisions

The Dodd-Frank Act's whistleblower provisions, found in Section 922, have also created substantial concern for American companies. The section mandates rewards for employees who voluntarily provide "original information" which leads to a successful SEC enforcement action. Critics fear that this will turn employees into corporate bounty hunters who ignore the normal compliance chain in search of riches.

The Act, however, need not mean the death of an organization's compliance program. Instilling a culture of compliance – through effective training, communication, and investigations – will convince employees that the best way to bring forward a complaint is within an existing corporate program.

This requires, among other things:

- An effective mechanism for allowing employees to report fraud, including a 24-hour hotline and processes to let the whistleblower know that a complaint has been acted upon;
- Comprehensive and fully documented investigations which thoroughly examine all reports and suspicious activity; and
- A strong tone from the top that lets employees know that the executives, the board of directors, and management have faith in, and rely on, the compliance program for ferreting out fraud and abuse.

The post-crisis regulatory environment is still evolving. Employers must continue to instill a culture of compliance and reporting among their employees and not be deterred by Section 922. As these efforts take hold, trust and loyalty will likely prevail over the hopes of riches and the predicted backlog of cases stemming from the new arrangements.

**Marcia Berss** is an associate managing director in Kroll's Chicago office specializing in public securities filings, corporate finance and corporate governance issues. She began her career as a corporate finance associate with Warburg Paribas Becker and was vice president in M&A for Dean Witter Reynolds.

**David A. Holley** is a senior managing director and the head of Kroll's Boston office. Since joining Kroll in 2000, David has led investigations including environmental matters, contests for corporate control, internal investigations and white-collar crime investigations.

**Lisa Silverman** is a managing director based in Chicago. She specializes in investigative cases for corporate contests, theft of trade secrets, patent infringement and product tampering.

# From Barings to Madoff: Lessons Learned

**Regulations are no match for human failings. As lawyers, financial investigators and chastened investors continue to pick through the rubble of the Madoff scandal and other massive frauds, new, more inventive versions of the same old story are being written**

On December 16, 2008, shortly after Bernie Madoff's arrest, a team of FBI investigators sealed off the crime scene at Bernard L. Madoff Investment Securities LLC in midtown Manhattan and started to sift through the evidence. Former FBI Special Agent Keith Kelly, who joined Kroll earlier this year as a managing director in its financial investigations unit in New York, was leader of the FBI criminal investigation. For months, he and his fellow sleuths combed through 13,000 boxes of records in Madoff's New York and London offices, revealing details of the scheme that bilked investors of an estimated \$18 billion. While still ongoing, the criminal investigation has led to five arrests, three guilty pleas and nearly \$8 billion recovered in forfeitures, helping to ease the pain caused by a massive scam that, for over 20 years, had fooled everyone.

## **The question now is – Will we be fooled again?**

To answer that question, let's first turn the clock back to 1995, when a rogue futures trader by the name of Nick Leeson based in Singapore lost a staggering \$1.3 billion on unauthorized trades, leading to the collapse of Barings, London's oldest merchant bank. "After Barings, people said 'This can't happen again,'" observes Richard Abbey, head of Kroll's financial investigations practice in London, "but then came Madoff."

But the Madoff scam was hardly an anomaly. Only three months before Madoff gained instant worldwide notoriety, the collapse of Iceland's three biggest commercial banks in quick succession led to a financial crisis that quickly spread to major investment funds across Europe. The bank failures spawned allegations of share manipulation, non-disclosed related party lending and shareholders yielding undue influence over the bank operations. Richard Abbey headed a team of Kroll investigators tasked by a government appointed trustee to investigate the Glitnir Bank case.

Barings and Madoff were not rare or isolated cases, just spectacular bookends. In between those two events was a constant torrent of

financials scams, which – while perhaps less colorful and certainly less publicized – resulted in financial ruin for unsuspecting investors across the globe.

What are the chances that, after the latest bout of pain caused by Madoff, investors and companies will remain more alert to red flags and more vigilant in applying the regulations and controls designed to thwart the scammers? It may be comforting to think so, but perhaps not realistic. "The problem," notes Zoe Newman, a 10-year Kroll veteran, who has investigated fraud and corruption cases from the Ukraine to China, "is that controls and compliance systems are implemented and operated by humans."

Humans, of course, are imperfect. The Madoff Ponzi scheme and the Icelandic Bank collapses are not so much tales of inadequate regulations or controls, but rather tales of people in charge who failed to implement and operate those systems correctly and investors who looked the other way.

Glitnir Bank provides a perfect illustration. Civil complaints filed by the bank appear to suggest that although the bank had set up a risk committee to analyze and approve loans in line with best practice, in reality it was often a formality. It is alleged that individual committee members were dominated by the bank's powerful CEO, who personally approved many of the loans.

The Madoff case is a similar blend of incompetence and denial. In hindsight, the problems, the lapses, the inconsistencies all seem so glaringly obvious. Despite numerous sweeps of Madoff's operation, SEC examiners never found evidence of fraud. And yet Madoff's elaborate hoax could have easily been uncovered if someone had done some due diligence on Madoff, particularly the phantom securities that he claimed to have purchased on behalf of his clients.

As for the investors, they easily rationalized their consistently high returns. If Madoff was a fraud, they told themselves, he would have been caught out long ago. "In the end people believe what they want to believe," says Kelly. "That's human nature."

Human nature is unlikely to change any time soon. Once the good times return, the painful memories will fade, complacency will set in and companies and investors will go back to the same patterns of denial. "Within a year, everything will be forgotten," predicts Kelly. "It's clear that risk aversion is already starting to decline."

The great American circus impresario P.T. Barnum is credited with coining the phrase "A sucker is born every minute." While that offhand dismissal of human gullibility may be accurate when applied to individual investors, surely large corporations, with their institutional checks and balances will not be so easily duped the next time. "The lesson that should have been learned is that every company can be defrauded and that you can't ignore that in good times," says John Slavek, a 13-year Kroll veteran, who heads a financial investigations team out of the Philadelphia office. "The fact is," adds Slavek, "that without fraud, companies could be doing even better." While crime pays (at least until you get caught) so too, argues Slavek, does fraud prevention.

So what is the likelihood that more companies will start making fraud prevention a priority? Again, it's mostly wishful thinking. "Very few companies are pro-active," concludes Slavek. "CEOs shake their heads at problems in other companies. Then it happens to them and they are shocked. When clients call us, there is usually a crisis and they are already feeling the pain."

More than two years after the collapse of Lehman Brothers and the unearthing of Madoff's elaborate Ponzi scheme, outrage and urgency are fading. The financial markets have recovered and many companies are enjoying record profits. In other words, conditions are ripe for more fraud. "People don't want to do preventative work to see if it's too good to be true. People move to the next big deal and it starts all over again," says Abbey.

And the next big thing might just as likely be in one of the high-risk emerging markets of India, China, Brazil, among others, which are attracting international investors in droves. "The big money is moving to new and un-regulated jurisdictions," observes Abbey. "There's little doubt that some investors will get burned."

As for the Madoff scam, we will still be talking about it for many years to come. Studies will show how the system broke down and that a lot of players in the market wittingly or unwittingly aided and abetted Bernie's grand larceny. "It always comes out that someone should have known," observes Abbey. "It's a similar pattern that repeats and repeats."

Like his colleagues, Kelly is under no illusion that the Madoff case represents a watershed in human history. "They may come in different shapes and sizes," concludes Kelly, "but there will always be Madoff schemes."

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