

Greater Houston Business Ethics Roundtable

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The Delicate Balance: Extending Your Ethics and Compliance Program to Third Parties

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The Delicate Balance

A Compliance Catch 22

- Controlling third parties seems increasingly important, yet increasingly risky

Key Questions

- How can an organization strike the right balance?
- What are other companies doing to mitigate risks?

We will explore

- The reasons to extend compliance outward and to be cautious in doing so
- The Conference Board Survey Results
- Some practical tips for navigating to an appropriate balance

Why Extend Compliance Controls?

Factors increasing risks

- Increased use of outsourcing, including outsourcing entire functions that were previously internal
- Outsourcing the handling of sensitive or confidential information
- Increased reliance on geographically dispersed parties
- Heightened awareness and visibility of supply chain management
- Accelerated pace of communications
- Increased concern regarding international labor and human rights

Why Extend Compliance Controls?

- Third parties can seriously damage a company's reputation
 - Mattel - supply of non-conforming or dangerous goods
 - Nike - allegations of poor labor conditions
 - Starbucks – allegations of poor labor conditions
- Legal liability
 - For conduct of agents
 - Less likely for other third parties (contract employees, suppliers, distributors, etc.), but some exceptions to this.
- Contracts may require third party controls
 - Information security
 - Anti-bribery/ Anti-corruption
- Third parties may harm company/employees
 - E.g. safety, security and harassment
- Ownership interests may be threatened
 - Joint ventures
 - Subsidiaries

Why not extend compliance controls?

- Increased risk of “**Associative Liability**”
 - Extension of compliance programs can create the perception of a control relationship
 - Risk of reputational harm or legal liability

Legal Guidance: USSG

- As appropriate, large organizations should encourage small organizations (especially those that have, or seek to have, a business relationship with the large organization) to implement effective C&E programs.
 - Application Note 2(c)(ii)
- Organizations shall take reasonable steps to communicate standards and procedures to directors, employees, and, as appropriate, *agents* by conducting effective training and otherwise disseminating information appropriate to the roles and responsibilities of each.
 - § 8B2.1(b)(4)
- Organizations shall take reasonable steps to have and publicize a system, which may include mechanisms that allow for anonymity or confidentiality, whereby employees *and agents* may report or seek guidance regarding potential criminal conduct without fear of retaliation.
 - § 8B2.1(b)(5)

Legal Guidance: SOx §301

- Requires audit committees of issuers to establish procedures for the receipt, retention and treatment of complaints regarding accounting, internal accounting controls and auditing matters.
- SEC Regs make clear that scope of the reporting requirements contained in section 301 extends to any relevant complaints received by the company, “regardless of [the] source.”

International Guidance

- OECD Guidelines for Multinational Enterprises
 - Organizations should encourage business partners, including suppliers and contractors, to apply principles of corporate conduct compatible with the Guidelines
- United Nations Global Compact
 - Signatories promise not only to respect human rights, but also not to be *complicit* in human rights abuses by others.

General Approach to Mitigating Risk

- Take a risk assessment-based approach
- Identify the risks presented by third parties
 - Risks unique to the third party functions
 - Risks of applying general compliance policies to third parties
- Carefully tailor compliance controls to the specific risks
- Create compliance strategies to mitigate associative liability risks

Using Risk Assessments

- Incorporate third parties into traditional risk assessment
 - For every risk considered for employees, also extend assessment to third parties
 - Consider the various categories of third parties separately
 - Consider the reasons for the risks – this helps determine the appropriate types of controls
- Consider the associative liability risks for each of the controls, and design measures to mitigate those risks

THE CONFERENCE BOARD SURVEY

- The Conference Board-ECOA Survey
- Conducted February – May 2007
- 169 Companies Respond
- 2006 Median Sales: \$5-10 Billion
- Diverse industries
- Majority of respondents are U.S. companies that also do business outside United States

Survey Says . . .

- 79% of responding companies conduct risk assessments as part of their E&C programs
- 76% of those companies that conduct risk assessments address third party risks
 - Agents, suppliers of services and contractors are the most frequent subjects
- 56% of those companies that incorporate third parties into their risk assessments do so as part of a broader enterprise risk process

Examples of Controls

- Code of conduct or other written policy directed at the company's own employees
 - Instructing/guiding employees in their dealings with third parties
- Survey says
 - 95% of responding companies have such policies in codes or other policies
 - Posted on Intranet – 88%
 - Posted on Internet – 68%

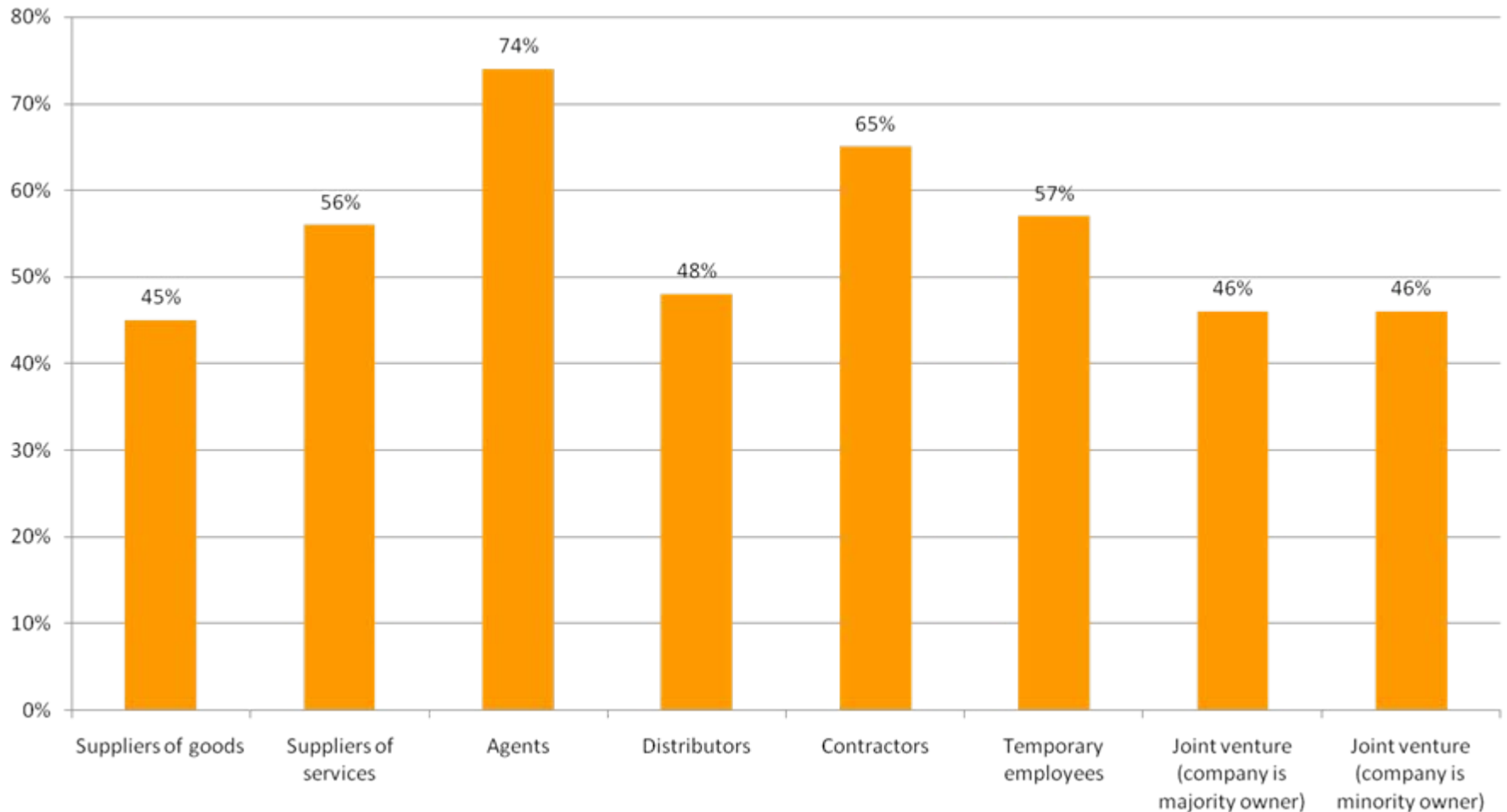
Examples of Controls

- Pre-relationship due diligence
 - Questionnaire
 - References
 - Financial issues
 - Litigation history
 - Reputation
 - Compliance Program
 - Certification/Assurances

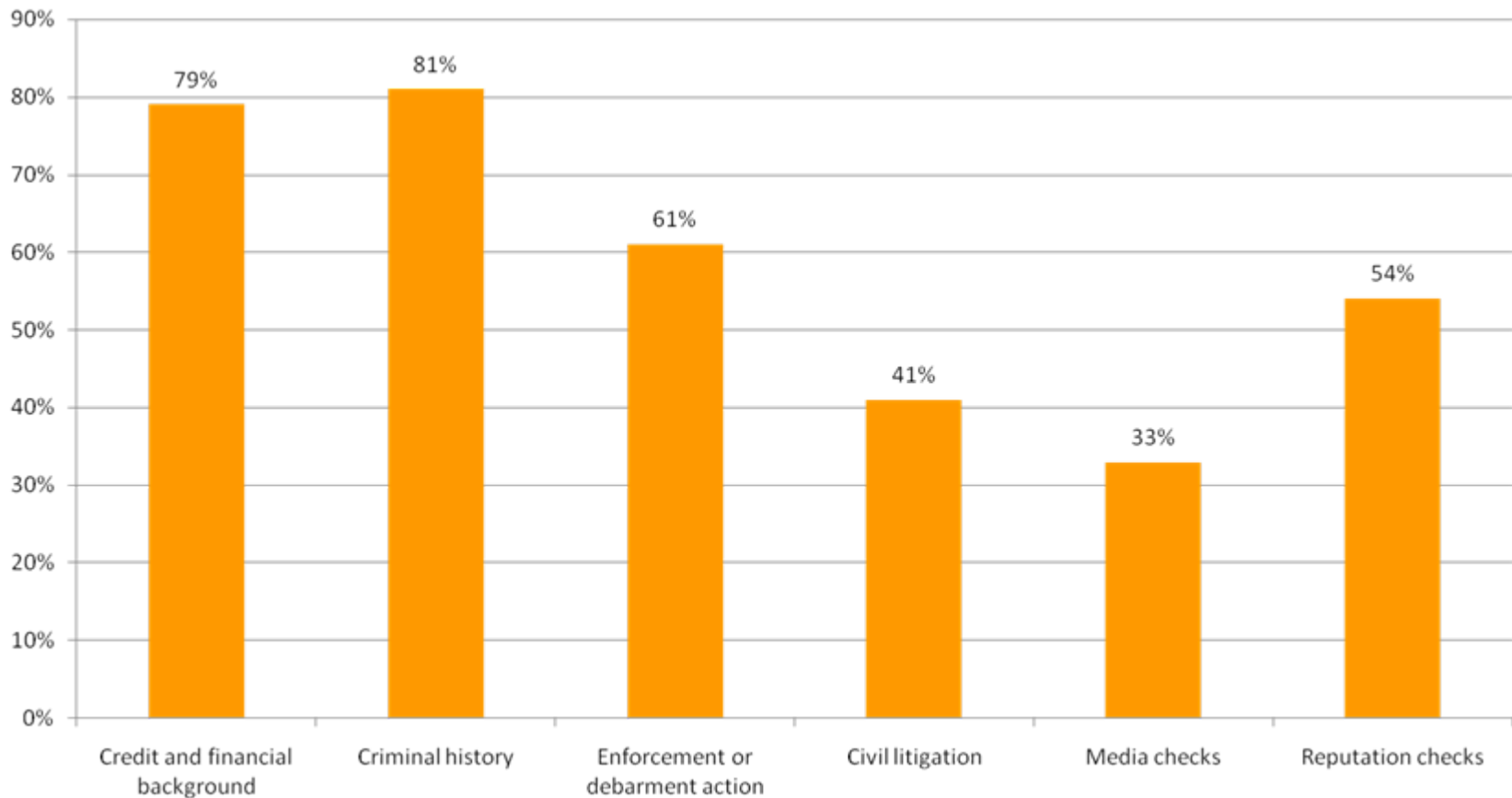
Survey Says . . .

- 77 percent of responding companies perform background/due diligence checks on *at least some* third parties prior to entering into a business relationship
- Companies are more likely to check for financial or legal concerns than for reputational concerns (media or reputation checks)

Company performs background or due diligence on:



In what areas is the third party subject to review?



Due Diligence Re E&C Program

- 28% of responding companies ask third parties whether or not they have E&C programs
- 14% ask for documentation regarding third parties' E&C programs
- Companies are more likely to seek information on the third party's E&C program when considering entering into a joint venture

Examples of Controls

- Contractual Undertakings
 - Compliance with law
 - Compliance with FCPA
 - Audit rights
 - Cooperation with investigations

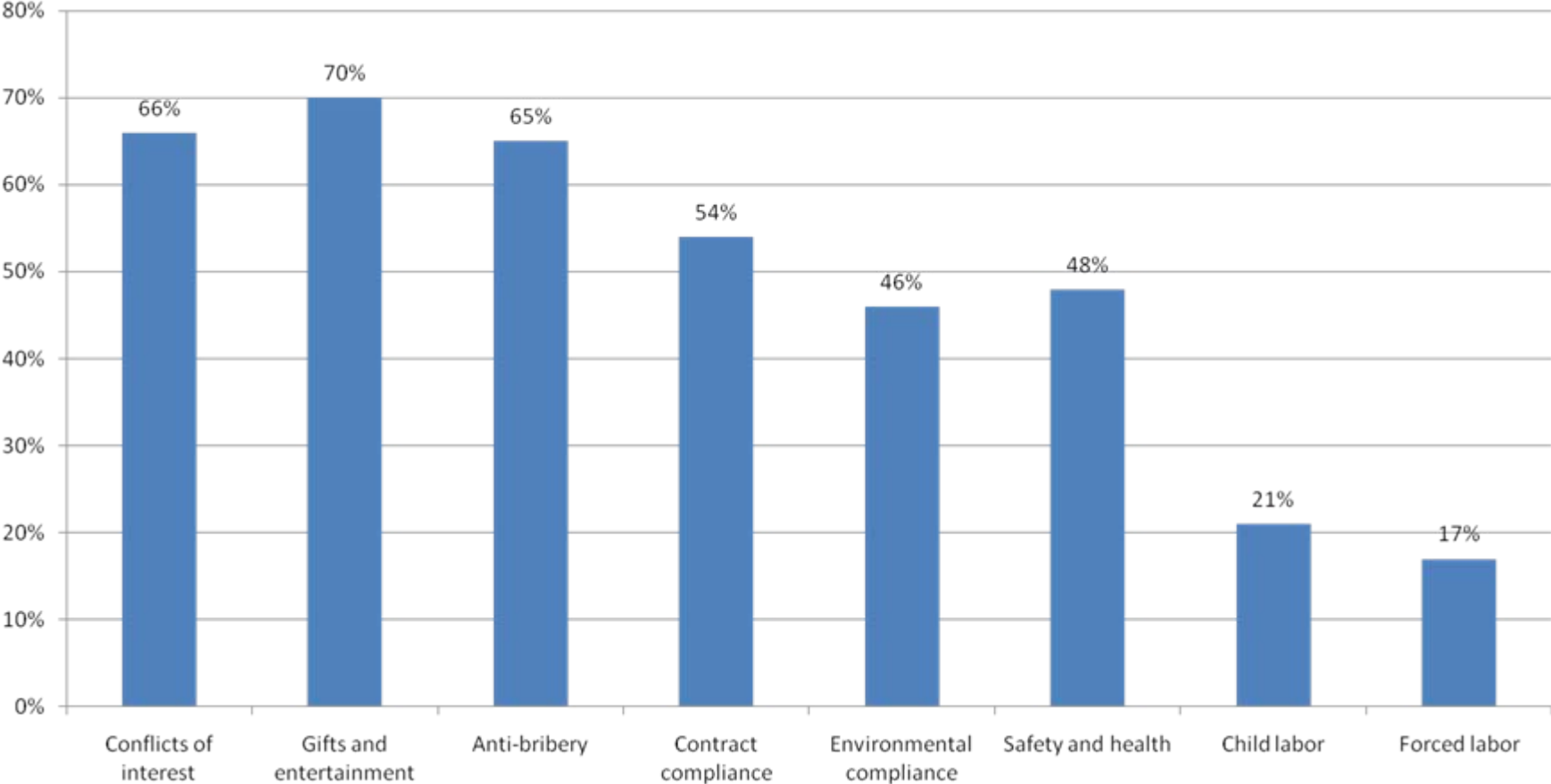
Examples of Controls

- Require third party to read/certify to
 - Your company's code
 - Other policies
 - Gifts/entertainment
 - Conflicts of interest disclosure statements
 - Anti-bribery
 - Political contributions
 - A code/policies drafted particularly for third parties
 - Ongoing compliance with laws
- Some companies are now requesting annual certification for some of the above

Survey Says . . .

- 25% of responding companies have a third party code of conduct
- Within this group, supplier codes are the most common – 81 %

On which subject(s) does the company have a written policy that applies to third parties?



Examples of Controls

- Other E&C communications
 - Letters (e.g., at holidays)
 - Vendor website with C&E communications
- Training
 - General compliance
 - Safety and health
 - Use of computer resources
 - Confidential information
 - Anti-bribery
 - Do not forget your disclaimer of third party rights
 - Notice/invitation
 - Start of training
 - Use of “company employees”

Examples of Controls

- Survey says:
 - 38% of responding companies offer (but do not necessarily require) some type of E&C training to third parties
 - Of those that offer training, 83% discuss their codes in the training content
 - In almost every case, those third parties that are asked to certify to a company's internal code of conduct are offered some type of C&E training.
- Topics
 - Gifts and entertainment
 - Anti-bribery
 - Conflicts of interest
 - Environmental compliance
 - Health and safety
 - Child labor/forced labor
 - Antitrust
 - Harassment

Examples of Controls

- Means for third parties to report concerns
 - Through means made available to employees generally
 - Through means designed for third parties (e.g., vendor or agent web site)
 - Query: How effectively to publicize reporting procedures to third parties' employees?
- Appoint individuals with oversight of third party compliance

Survey says . . .

- 86 % of respondents offer third parties a means to report suspected misconduct
- Of this group, 2/3 have provided reporting avenues to third parties for more than 3 years
- 98 % use the same system for third parties as for their own employees
- Types of reporting procedures:
 - E-mail: 65%
 - Helpline directed to independent service provider: 61%
 - Internally-answered helpline: 51%
- Calls/inquiries from third party employees are uncommon

Examples of Controls

- Audit to ensure that third party acts as required by company policy
 - Include in procurement documentation a requirement that third party cooperate with audits and investigations
 - Not always practical or well-received

Survey Says . . .

- Companies that audit third parties: 35%
- Of that number, those that audit on a routine basis: 45 percent
- Those that audit when there are specific concerns: 55 percent
- Those third parties more likely to be subject to an audit:
 - Suppliers of services (58%)
 - Contractors (56%)

Associative Liability Risks

Third party beneficiary claims:

- Wal-Mart
 - Int'l Labor Rights Fund brought suit against Wal-Mart in 2005 on behalf of a purported class of Bangladeshi, Chinese, Indonesian, Nicaraguan, Swazilander and U.S. workers, alleging violations of Wal-Mart's code of conduct for suppliers
 - Allegations:
 - Wal-Mart has a legal right to audit suppliers for compliance with labor standards
 - Plaintiffs, who are workers at supplier factories, are third-party beneficiaries of Wal-Mart's contracts with its suppliers
 - Wal-Mart's right to inspect suppliers creates a duty to inspect for compliance
 - Wal-Mart's failure to audit and adequately monitor the suppliers violates its contractual duty to its suppliers' employees
 - The complaint was dismissed by the trial court; currently on appeal

Associative Liability Risks

- Employment relationship
- Veil Piercing – although high threshold
- Potential principal/ agent relationship with joint venture
- Public association of the third party and your company with respect to the wrongful conduct as a result of control efforts

Mitigating The Risks

- Create realistic expectations
 - The less control a company has over a third party, the less ambitious its public promises should be regarding that party's compliance
- Carefully tailor the organization's compliance role
 - Companies should carefully articulate any rights they choose to assume to monitor a third party's compliance
- Disclaim the creation of third party rights
 - Consider including language in supplier codes and other relevant documents and training disclaiming the creation of rights in third parties

Mitigating The Risk

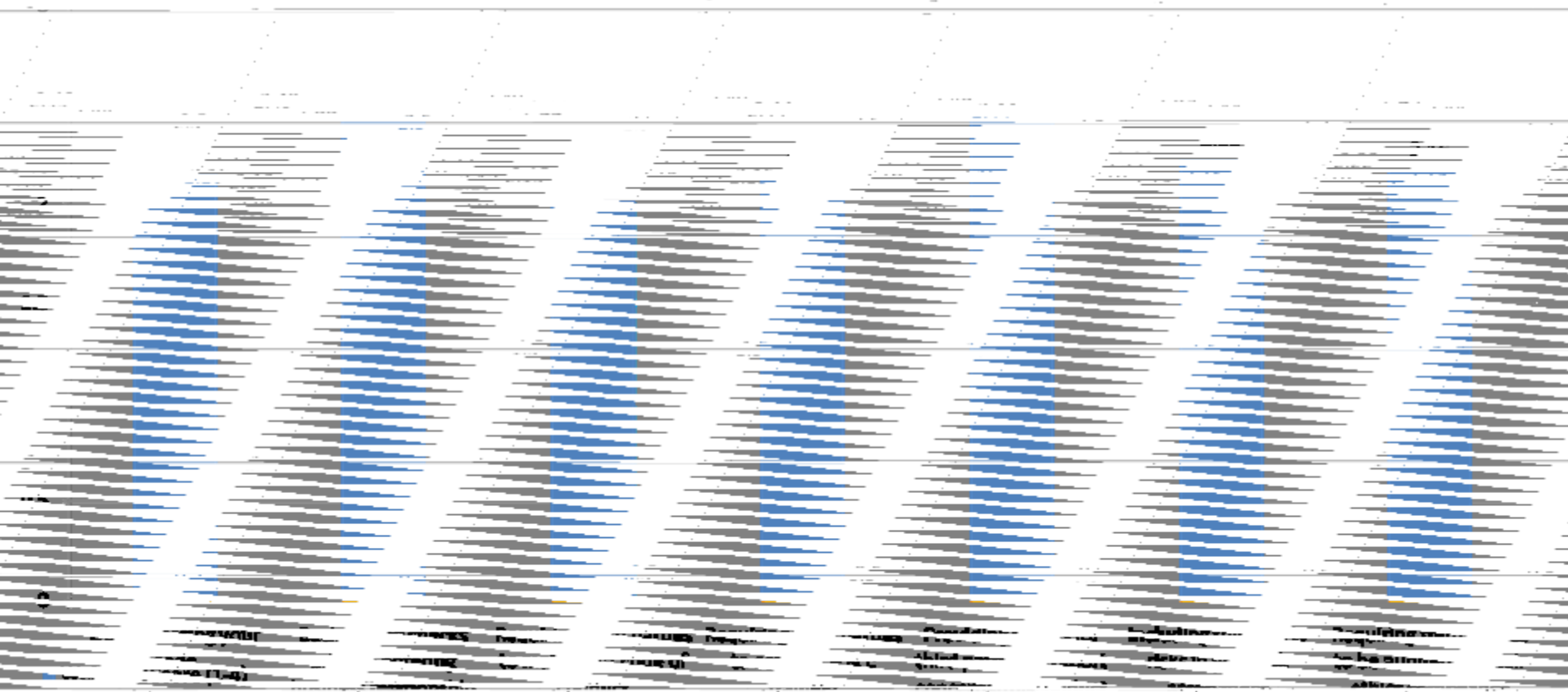
- Ask third party employer to communicate E&C standards
- If a JV or other relationship where your company is providing the E&C tools, attempt to customize them to the third party
- Limit your company's involvement in the investigation of reports of suspected misconduct

E&C Elements Extended to Third Parties: A Summary



How difficult a challenge is posed by the following in trying to ensure ethical behavior by third parties?
(1=not difficult 4=extremely difficult)

How effective are the following measures in ensuring compliance with appropriate standards of business conduct by third parties?
(1=not effective 4=extremely effective)



Where Do We Go From Here?

- More focused, risk-based C&E standards, based on risk assessment
- More and better due diligence
 - more sophisticated, reliable and focused background checks
 - embed C&E due diligence in the acquisition and jv process
- More and better publication of reporting procedures