

## ESG



## Sustainability Research

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## Bribery &amp; Corruption

## The Trillion-Dollar Challenge

World Bank estimates put global per annum bribes paid at USD1 trillion. However, regulations are now stronger than ever and this trend is set to continue. We look at the relatively recent recognition of bribery as a business risk, and at the companies and some of the sectors most affected. This report aims to help investors protect themselves against a specific and growing reputation risk and serves as both a primer on the theme and an analysis of some key sectors and companies.

■ **It's official – Prevention is better than cure**

A company does not have to be found guilty of bribery to be prosecuted under the new UK Bribery Act. It needs only to be found guilty of not having "adequate procedures" to prevent corruption.

■ **Whistle-blowing has never been this lucrative**

Several Dodd-Frank Act provisions build on the work started in the Sarbanes-Oxley regulations to reward whistle-blowers financially, with significant amounts – thereby potentially increasing the overall use of whistle-blowing mechanisms for direct reporting to US authorities. We note whistle-blowing is already a primary channel of information in bribery cases.

■ **Identifying corruption risks: The Cheuvreux Guide for Investors**

We look at the comprehensive set of structures and indicators that measure corruption risk and allow you to engage with companies in the most effective way.

■ **Third parties, acquisitions and subsidiaries pose the greatest risk**

The weakest points of anti-corruption processes may lie with JVs, third parties, acquisitions and subsidiaries. Companies without established systems to deal with these external parties will have to apply anti-bribery procedures to their procurement and supply chains rapidly and robustly.

■ **Biggest changes to come in the extractive industries**

Following the long-standing voluntary EITI initiative to prevent corruption by promoting revenue transparency by governments and companies at a country level, Dodd-Frank provision 1504, slated for introduction by June 2012, will require transparency from US-listed extractive companies on their payments to governments. The EU is preparing similar legislation, due out later this year.

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## A note on our approach to sources

We neither confirm nor deny allegations reported by the media in including them in this report. ESG analysis requires us to consider all stakeholders and media sources in order to assess potential reputation risk for investors. In this report we use a variety of journalistic sources, including local ones where we feel they reflect a relevant area of risk. Often allegations will surface long before evidence is objectively presented or any official announcements either by authorities or even less so by companies themselves. They are however of central interest to investors as news flow, and critical within the context of reputation risk that we examine.

All sources mentioned as allegations are systematically referenced in the Notes (from page 67) in order to be traceable.

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## I – A changing paradigm for business ethics

The impact is both  
reputational and  
financial

Anti-corruption  
enforcement is a  
recent trend

Major new regulations  
in the UK...

...and in the US

China and Russia  
pose increasing risk

Unethical perhaps, but  
why a business risk?

Its not just the  
penalties, future  
revenue can be  
blocked

According to the World Bank, at least **USD1tn is paid in bribes worldwide** each year. Companies are increasingly being targeted for corrupt practices – even if they are only proved guilty of turning a blind eye to them. As regulations are being tightened in several territories, notably the US and the UK, we believe that the main risk continues to lie in reputational damage and financial costs, both direct and indirect. Total final penalties are increasing along with the potential for reputational impact, and a further risk to revenue is noteworthy: the loss of contracts and the risk of debarment or exclusion from bidding processes. Not only national procurement departments (particularly in defence and infrastructure), but also multilateral agencies (e.g. the World Bank or the UN) may debar companies found guilty of corruption charges, thereby excluding them from important and sometimes fast-growing markets.

Corruption is a **relatively recent business risk** and therefore the full powers of legislation in most countries (even the strongest enforcers) are untested due to their infancy and a lack of political will to pursue cases publicly through the courts. Indeed, enforcement is focused within a small group of active countries led by the US since 2006. We emphasise the cultural change affecting companies in the regulatory approach to corruption; until 1998, *bribery was not only legal, but a tax-deductible expense* in Germany.

The US levied USD100m in fines and penalties (disgorgements) in 2011 against corruption, but the total is **over USD2bn since 2009**: we summarise some of the penalties paid by individual companies in recent years and break down the key components of risk exposure. Best practices are highlighted with key risks for most exposed sectors.

In terms of regulation, the UK passed a **new law in 2011**: the UK Bribery Act. We look at its major new facets and the effects on global investors. The US introduced **financial incentives for whistle-blowing** under the Dodd-Frank Act in 2011: aside from potential payouts in millions of dollars, the publicity surrounding the new amendments is likely to raise awareness of corruption as well as reward successful informants. The impact on companies caught on the wrong end of this act is likely to be large in terms of reputational damage. Furthermore, Dodd-Frank provisions have been passed that are aimed specifically at combating corruption in extractive industries through the means of revenue transparency for US listed oil, gas and mining companies.

**Geography has always been a strong indicator of corruption risk.** With increasing trade and M&A in emerging markets, European companies need risk assessment tailored to their new markets and due diligence in their expansion strategies both organic and acquisitive. **China and Russia** score very highly in country risk ratings for bribery – posing new risks for those with rapidly increasing presence there.

### ■ Bribery allegations: The corporate impact

**Reputational impact** is the first but not the only area where companies are at risk. Media coverage of scandals has an immediate impact on the image of companies, and the fallout can be felt in several areas:

**Staff losses** are likely to be experienced at all levels, not least the CEO and board level in the worst cases. There are recruitment effects, with surveys showing that employees prefer companies branded as having higher levels of ethical responsibility<sup>1</sup>.

Although the financial repercussions are not generally the primary concern of analysts covering companies in order to the value them, the onset of allegations itself is the driver of reputational damage with often an accompanying loss of short-term market value and subsequently a variety of direct and indirect financial losses (not least through investigative and compliance costs). These can be visible through the loss of clients and contracts well before judgment or settlement.

### Bribery has financial consequences

The **settlement process tends to be lengthy**, with court cases of three years or more being typical and final judgments for acts often committed eight to ten years prior to fines and disgorgement, the larger part of the payments. The act of corruption is likely to lie dormant for several years before discovery. In several major cases we find a time lag of over five years between the initial act of engaging in an illicit payment and subsequent internal investigations or external allegations

As well as fines for violation of bribery laws and the return of profits obtained by illegal acts (known as "disgorgement"), there are other various direct impacts on the bottom line, as summarised in the following table.

#### DIRECT FINANCIAL COSTS OF SETTLEMENTS

Bottom-line effects	Description	Examples
Back taxes	Bribes uncovered often leave an audit trail that interests tax authorities	A variety of major cases have imposed back taxes payments for those taxes unpaid as a result of gains from bribery
Prejudgement Interest	This is the interest payment required from the time of the offence to the date of settlement	Smith & Nephew's final SEC settlement included an element for prejudgment interest <sup>2</sup>
Investigation costs	Authorities will often leave the companies accused to "self-investigate" – in practice, this means hiring teams of external lawyers to present the case and its evidence. These costs will sometimes be higher than the total penalties themselves.	Internal investigation costs estimated at USD950m for Siemens. Smaller cases can still result in large-scale costs, e.g. an estimated USD130m in costs for Avon's alleged FCPA violations <sup>3</sup>
Compliance costs	In many cases, a "monitor" will be appointed by prosecuting authorities	Siemens <sup>4</sup> and Alcatel-Lucent <sup>5</sup> were required to appoint compliance monitors and to bear the costs

Source: SEC, DOJ, Avon Company Filings

### Modest free cash flow elevates the risk

Although all investors are more at risk of seeing a **lower return on investment** from companies engaging in corruption, a potential impact of the direct costs detailed above is magnified in companies without adequate liquidity. **Companies with modest free cash flow** are particularly susceptible due to the high costs of investigations. Non-investment grade firms and those without large cash balances are therefore clearly more at risk.

#### Contract losses

We note that corruption allegations, whether proven or not, have a direct impact on contracts under negotiation and order books. There is a risk of contracts being withdrawn or negotiations halted as a direct result of negative news flow from public scandals.

Key clients may defect either temporarily or permanently in cases in which they do not wish to be associated with poorly branded companies. They may also introduce new clauses requiring implementation of stricter anti-corruption controls. Lastly, clients may use reputation loss as leverage to renegotiate on the basis that branding or intangible value within the supply chain has been diminished.

It should also be noted that contracts found to have been initiated via bribes are likely to be rendered invalid and the costs of renegotiation maybe significant.

#### Debarment

The **worst-case scenario** for companies is to be excluded from government and international bidding processes, or "debarred". We note that this is a politically sensitive topic and has not been governments' preferred option – notably US authorities have opted for settlements or Deferred Prosecution Agreements (DPAs), which are more convenient and less expensive for the justice system. Prosecution with DPA agreements

### Companies may lose major contracts...

No definitive  
correlation beyond the  
short term

often involves no actual admission of bribery, but instead charges related to associated crimes such as false bookkeeping. A provision to allow automatic debarment from US government contracts has been under review but has not been passed.

Institutions such as **the World Bank<sup>6</sup>** and **the United Nations** use **debarment** more frequently than national governments and have applied it to, for example, Siemens Russia, excluded from World Bank projects from November 2009 to 2013, and Macmillan Publishers from April 2010 to 2016 (reducible to three years upon "continued cooperation")<sup>7</sup>. Siemens also suffered UN contract debarment<sup>8</sup> for six months, with its Russian subsidiary suffering a four-year debarment (and not even allowed to contest this, according to the official settlement conditions as per World Bank Documentation<sup>9</sup>).

The 2004 **EU Procurement Public Procurement Directive** states that when a company or its representatives have been found guilty of bribery, they can be debarred in perpetuity from EU bidding. Public procurement represented 13.5% of EU GDP in 2007, so if applied, this rule would represent a significant threat to companies. However, it remains largely untested, with no major European corporations having been excluded thus far.

As an illustration, a recent case of **national government debarment** concerns Rheinmetall's Zurich-based air defence division: it was excluded from Indian defence procurement contracts for ten years as a result of an investigation alleging it had paid bribes to obtain its contracts<sup>10</sup>. Although India was estimated as a small area of revenue (<1%) by our analyst, there is clearly reputational damage and a future fast-growing market has been blocked for this company. Rheinmetall denies the claims and we wish to clarify that we do not declare any wrongdoing on Rheinmetall's part.

### Market value

The effects of corruption allegations on share prices are difficult to correlate over the medium and long terms, and any efforts to do so show variable results and no definite trend. However, there is usually a **short-term plunge** in share prices following negative media stories, as illustrated through the examples in the following table.

### ONE-DAY SHARE PRICE DROPS ON NEWS FLOW

Company	Headline title & source	Date	Share price drop (%)
Finmeccanica	"Finmeccanica drops; Reports of Alleged Bribery Investigations as much as 8.4%", Bloomberg	27 Feb. 2012	8.4%, Milan
Wal-Mart	"Wal-Mart drops the most in almost a year amid bribery probe", Bloomberg	23 April 2012	12%, Mexico 4.7%, New York
ENRC	"ENRC shares fall sharply, despite denial of corruption charges", Digital Look	12 Dec. 2011	6.5%, London
News Corp	"News Corp shares fall as pressure grows", BBC News	18 July 2011	4.3%, New York 7.6%, Sydney
Embraer SA	"Embraer declines most in a week on corruption probe concern", Bloomberg	7 Dec. 2011	1.7%, Sao Paulo

Source: Newswires

Receiving bribes  
reduces efficiency of  
capital allocation

### Capital expenditure

For companies receiving bribes to award contracts, **capex** efficiency suffers. This results from bribes initiated by suppliers or requested by company decision-makers, where the most common symptom is inflated contract prices to increase supplier revenue in return for bribes allocated to those responsible within relevant departments such as purchasing and finance.

**Material financial misstatements mean investors can sue**

The direct impact on expenditures may also be that the company over pays, sometimes for years, without knowing it due to bribes accepted to implement sub optimal or over priced contracts.

### Litigation risks for companies

A company may be subject to several types of litigation:

**1) Civil claims** by national enforcement agencies such as the SEC in the US, other companies or individuals: these result in monetary fines and penalties or even requests to repay dividends acquired from holdings or subsidiaries found guilty of bribery.

**2) Criminal claims** by agencies such as the DoJ (US Department of Justice), where guilty individuals may be sentenced to prison terms

**3) Shareholder lawsuits** – institutional shareholders may pursue companies for damages to loss of value of their holdings, particularly if there have been material financial misstatements as a result of bribes.

Below are some illustrative cases chosen because they are well known; however we do not make any explicit judgements against the companies we mention here:

An example where a company faced such allegations is that of **BAE Systems**, where the City of Harper Woods Employees' Retirement System in the US attempted to bring a shareholder lawsuit against BAE, to recover its direct losses following corruption allegations<sup>11</sup>. The lawsuit was dismissed in 2009 as it faced considerable legal difficulties, not least concerning the jurisdiction between the US and the UK. We note that BAE denied and contested all allegations brought by Harper Woods.

Law firms in the US may also solicit shareholders for class action suits following corruption settlements – as has been the case with insurance company Aon.<sup>12</sup>

**Siemens was sued by shareholders** in December 2009, through a US class action for securities fraud related to the misrepresentation of the potential impact of corruption litigation by the conglomerate.<sup>13</sup> This case was also dismissed, in 2011, one factor being the lack of precise evidence to support the claim.

**Panalpina** was also sued in 2009 by four related investment companies that held approximately a 5% stake in Panalpina. These investment companies alleged that the stock lost significant value due to corruption. A settlement was reached in August 2010.<sup>14</sup>

While shareholder lawsuits have been restricted to being a mainly US phenomenon, the new UK Bribery Act, with its emphasis on adequate procedures, makes it feasible that under UK regulations (combined with regulations in the Companies Act 2006, which widened shareholders' recourse) shareholder suits may be more readily pursued in the UK against companies when evidence emerges that they have failed to protect investors against losses from corrupt activities.

**4) Business partner lawsuits** – Partners may sue to save their own reputations by distancing themselves from the company through litigation. An example is the case against BP, Statoil and British Gas brought by Grynberg, where the stated motivated was to limit reputational risk:

In April 2008, Denver-based oil company Grynberg Production Corporation filed suit against **BP**, **Statoil** and **British Gas**, alleging that these companies had used nearly USD12m from the partnership to bribe Kazakh officials<sup>15</sup>. Jack Grynberg, founder and CEO of the company, stated that the suit was primarily intended to distance himself and his company from any potential FCPA violations by his joint venture partners. In November 2008, however, this case was dismissed in the US and is now being pursued via EC courts.

**Lawsuits can also be filed against corrupt partners to protect reputation**

**An active culture of bribery can have numerous negative fallouts**

**Sentencing of individuals prolongs reputational risk long after corporate settlements are finalised**

**Local sources report that China applies the death penalty**

## Company culture: Symptoms and impact

The use of bribery is marked by undeclared acts and short-term gain that diminishes long-term efficiency of operations. Furthermore, it is not only in the area of procurement that bribes may be offered or accepted, corruption can also be used to circumvent health & safety, licensing processes and taxation as well in the corporate sphere.

- In some cases, bribery has the potential to **stifle innovation** in all sections of the company if suppliers and management are chosen not based on merit but on the ability to generate, use and cover up illicit payments.
- Bribery fosters a **lack of accountability** – in numerous cases senior management have denied knowledge of the wrong doing by persons within their firms or even direct subordinates. **Weak governance** will tend to magnify this lack of accountability.
- **Authoritarianism**, with reduced transparency over the apparent successes of individuals and departments – management influence becomes more rigid and less open to change or challenge.
- As the natural result of a more secretive culture in companies where bribery occurs, **departments and teams will tend to work more in isolation**, discouraging information sharing and cooperation between units.
- Ultimately, results at the company, division and employee levels are **not based on true performance**.

## ■ Executive penalties mean reputational effects live longer

*"Criminal fines are added to the costs of doing business... Going to jail is what works to deter crime."* – US Senator Arlen Specter

Executives found guilty of corrupt practices are usually on trial long after corporate settlements have ended. In large cases the media will not fail to report them and the implication of board level executives magnifies the damage further.

Though prison sentences are still rare they are included in bribery legislation with maximum sentences of five years under US law, and 10 years in the UK. Most countries around the world allow for prison sentences but it is still unusual to see them applied.

In February 2012, the former chief executive of US engineering company KBR Inc, Jack Stanley, was sentenced to 30 months in prison for his involvement in a co-ordinated Nigerian bribe scheme related to LNG gas contracts worth USD6bn<sup>16</sup>. The corporate settlement of USD579m was finalised several years before in 2009.

The risk of continued reputational impact is therefore not negligible, as key executives associated with the company usually receive significant monetary penalties and in rare cases prison sentences.

According to local sources China has applied the death penalty in a case related to a China Mobile executive in that country. The local source reports that in a closed trial in 2011, a human resources director at China Mobile was sentenced to the death penalty for his involvement in bribes between the company and Siemens. Another individual who acted as intermediary received 15 years.<sup>17</sup> We are unable to confirm the facts of this case.

Reputation aside the time lag in bribery cases means that the management involved in investigation of the case internally may not have been involved or even employed by the firm at the time alleged acts may have taken place. Operationally significant resource may be required to find archival material dating back years to present in investigations.

**No “money-back  
guarantee” if the bribe  
doesn’t work out...**

### **An inefficient way to acquire and retain business**

And finally as an operational method, it should be noted that even if a bribe is not detected, the company can lose business as competitors "out-bribe". Even in a case in which the bribe is accepted, it does not always lead to winning the contract, as the very nature of entering into improper incentives lies outside policeable codes and lacks visibility in terms of its exact payback at all stages of its use. And far from being a one off payment bribery can open the way to extortion where payment requests can become ongoing.

**The majority of cases worldwide have been the result of the FCPA**

## II – Regulations and reputations

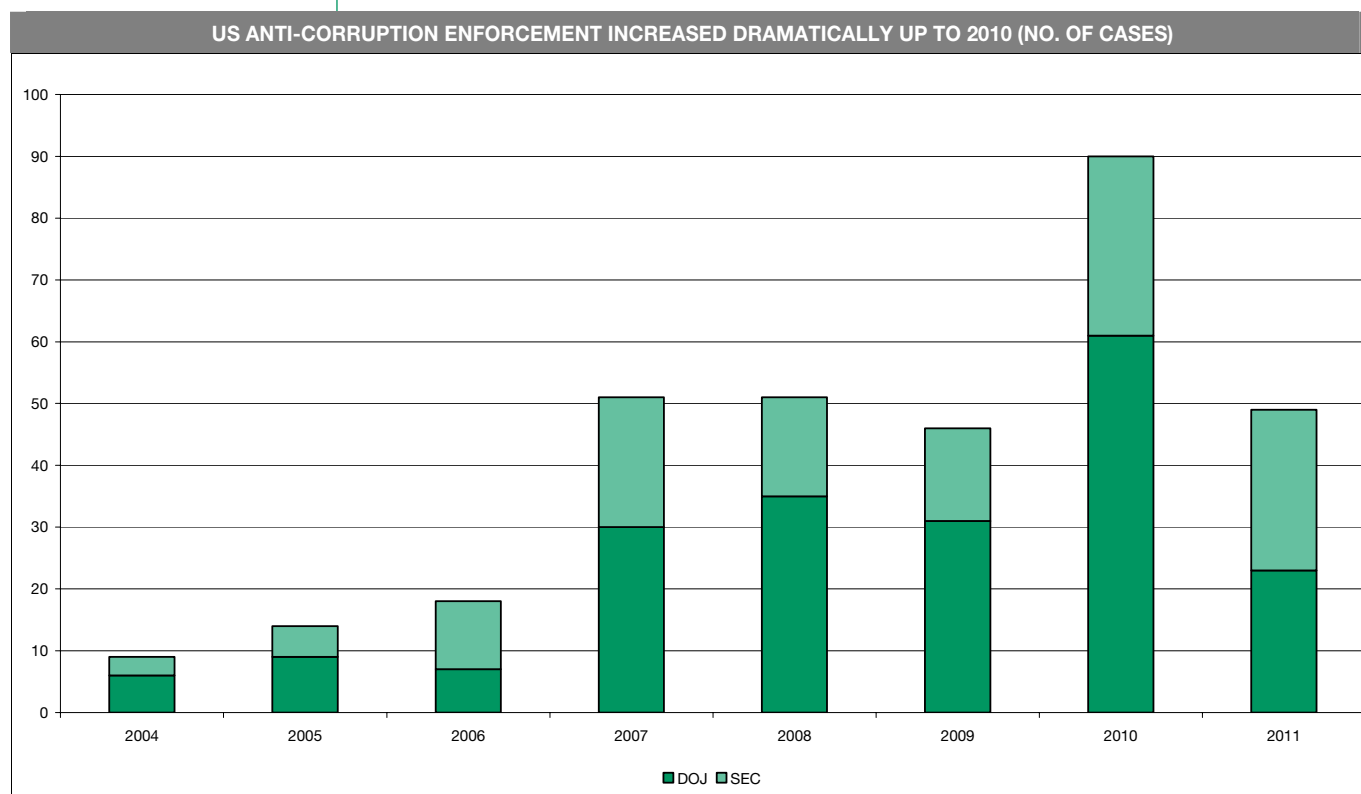
### The Foreign Corrupt Practices Act (FCPA) in the US

Within the global context, the **US is still the major prosecutor of corruption, pursuing more cases than all other countries combined**. Both companies and investors should view US corruption regulations in the context of their global enforcement.

The original FCPA was introduced in 1977 in the aftermath of the Watergate scandal, following news and disclosures that showed that over 300 US businesses had set up generic accounts or slush funds in order to obtain business, particularly abroad, by paying bribes.

The FCPA applies wherever bribery has taken place in the world as long as there is a connection with the US: i.e. bribery may involve US bank accounts, citizens, SEC-listed companies, a US subsidiary based abroad, or most relevantly a foreign company with a US subsidiary.

The law has a strong emphasis on bookkeeping requirements, hence the misstatement of financial positions that necessarily accompanies bribery is often used in prosecutions.



The following table clearly shows the scope of FCPA prosecutions: seven of its ten largest cases have involved European companies, all with market caps of EUR1bn or more, and have taken place in the past three years.

## THE LARGEST ANTI-CORRUPTION PROSECUTIONS TO DATE UNDER THE FCPA (EUROPEAN COMPANIES IN BOLD)

Company	Country	Sector	Year	FCPA settlements (USD m)
<b>Siemens</b>	Germany	Capital Goods	2008	800
KBR / Halliburton	US	Oil & Gas/ Engineering	2009	579
<b>BAE Systems</b>	UK	Defence	2010	400
<b>Snamprogetti Netherlands B.V. / ENI S.p.A</b>	Netherlands/Italy	Oil & Gas/ Engineering	2010	365
<b>Technip SA</b>	France	Oil & Gas	2010	338
JGC	Japan	Engineering	2011	219
<b>Daimler AG</b>	Germany	Auto	2010	185
<b>Alcatel-Lucent</b>	France	Telco	2010	137
<b>Maygar Telecom/ Deutsche Telekom</b>	Hungary/ Germany	Telco	2011	95
<b>Panalpina</b>	Switzerland	Transport Services	2010	81.8

Source: DoJ, SEC

A UK law with a global impact on corporates

The law covers inadequacy of preventative anti-corruption systems

### ■ The UK Bribery Act

"The sort of case that we will be interested in is one where **the bribe paid disadvantages an ethical UK corporation**. In such a case there is a strong UK public interest in bringing that foreign group before the UK Courts. This will be a **high priority for us**."- Richard Alderman, Director of the Serious Fraud Office

By contrast to the FCPA, UK regulations are less established, and the newest regulation having only been introduced on 1 July 2011 in the Bribery Act. Although this is a UK law, it is expected to have wide global repercussions due to its extended scope. The Bribery Act has the potential to put the UK at the forefront of anti-corruption litigation, and therefore **European companies should be prepared**.

The law introduces several new features that make it, in theory, the most comprehensive legislation worldwide. Conclusive evidence of bribes need not be found for charges to be brought with this act - as long as there is evidence of a lack of "adequate procedures" to prevent corruption a company is at risk.

### Who is covered?

The official guidance for the UK Bribery Act is not detailed in terms of which parties it may apply to. Instead, it uses the phrase "**with any business activity in the UK**", leaving the exact jurisdiction open in principle.

However, if a company has a UK listing, vendors, intermediaries or employees, it is likely to fall within the Act's scope. But public interest may be the driver in pursuing cases – i.e. if a UK corporate lost a tender due to foreign bribery.

**The UK Bribery Act is seen by some commentators as being stricter than the US Foreign Corrupt Practices Act**, for several reasons;

- **Facilitation payments** or the payment of small bribes to government officials are included in its scope: the long-term objective seems to be to eradicate these.
- It prohibits actual and attempted bribery of **private citizens** as well as government employees (so the scope is much broader).
- Not just the bribe payer (or the "supply side"), but the **bribe recipient** (requestor) is also liable. (The first prosecution under the act was of a UK court clerk requesting payments in driving violation cases.)

■ **Penalties are harsher:** The FCPA calls for sentences of up to five years per offence, whereas the Bribery Act calls for up to ten years per offence. UK penalties are unlimited, but US penalties include fines only up to twice the amount of the bribe received or USD2m per violation, whichever is greater; individuals are liable to USD250,000 per violation under the FCPA.

■ **Corporate liability** for a company that failed to prevent bribery is the driving force of the act through the requirement for "**Adequate Procedures**".

However we note that with the exception of facilitation payments the other areas may be covered in US law by non FCPA legislation.

## WHAT ARE "ADEQUATE PROCEDURES"?

Six principles are outlined in the UK Bribery Act:	
Proportionate procedures	With larger firms required to exhibit a bribery prevention policy in line with the size, scope and nature of the business. Evidence should exist that it is clear, practical, accessible, properly implemented and enforced.
Top-level commitment	The board should take responsibility for the prevention of corruption, and enforce "zero tolerance".
Risk assessment	To take into account both internal and external risks "in respect of persons who perform services for or on behalf of the organisation" in a periodic, informed and documented fashion.
Due diligence	Proportionate and risk-based due diligence, with procedures in place to mitigate identified bribery risks.
Communication	Policy and procedures embedded and understood throughout the organisation through internal and external communication, including training.
Monitoring and review	Oversight of procedures and policy, with improvements made where needed.

Source: Serious Fraud Office (SFO), CA Cheuvreux

### Adequate procedures are a legal defence in the UK

Adequate procedures can be put forward as a legal defence in the UK when an individual has committed an act of bribery within a corporation.

The idea is that **although there may always be individual employees whose behaviour cannot be controlled, there should be a comprehensive system that ensures anti-bribery norms throughout the firm.**

Although the US FCPA does not allow a full defence for a company through "adequate procedures", it does allow at least a 50% reduction in the amount of a fine and favourable settlements provided:

- Individuals with operational responsibility have direct reporting obligations to the company's governing authority or appropriate sub-group
- The compliance department or ethics programme detected the offence before external discovery or before the discovery was reasonably likely
- The company quickly reported the offence to the relevant authority (i.e. no cover-up)
- No individual with responsibility for compliance took part in the offence or ignored it

Although, at the time of writing, the UK Bribery Act has not yet been used against corporations its impact is expected to be major and early test cases will likely receive heightened media and legal attention – thereby increasing reputation risk even further for those companies charged.

**Whistle-blowing  
hotlines help prevent a  
culture of bribery**

**Blowing the whistle  
has never been more  
rewarding**

**The whistle-blower  
could  
get 10-30% of the final  
penalty**

## ■ Whistle-blowing and the Dodd-Frank Act

Whistle-blowing is usually a "hotline" system by which acts of wrongdoing can be reported. We believe the best practice is for such a system to be outside the typical internal reporting hierarchies, as potential complicity within the management chain may have a negative impact on the willingness to report issues and also the subsequent effectiveness of any investigation.

A recent Deloitte study found that approximately half of whistle-blowing calls are related to personnel issues and a significant number of the calls may be dead ends and of a non serious nature. However, many bribery cases have surfaced as a result of whistle-blowing including a recent Kuwait incident with Siemens. When an incident is reported and dealt with through internal channels, but also publicly disclosed, this can be considered a strength.

The US Dodd-Frank Act has introduced provisions that will pay successful whistle-blowers, and, in October 2010, the SEC announced it was setting up a USD452m fund for Dodd-Frank informants.

The **conditions of payment** are as following:

- Sanctions received by the SEC must total USD1m+
- The "guilt" of the whistle-blower must be taken into account – the above sum excludes fines to the whistle-blower himself and any profit to the company caused by the whistle-blower's illicit activity
- Employees are discouraged from avoiding internal corporate whistle-blowing schemes
- Foreign government officials may not enter this programme – the idea is that the US, for diplomatic reasons, wants to be seen as avoiding the direct pursuit of external state matters.

Although the Dodd-Frank provision is new, whistle-blowing has been well established under US law, with Sarbanes-Oxley regulation Section 301 (4) as follows:

"Each **audit committee** shall establish procedures for the receipt, retention and treatment of complaints received by the issuer regarding accounting, internal accounting controls, or auditing matters; and the confidential anonymous submission by employees of the issuer of concerns regarding questionable accounting or auditing matters."

Whistle-blowers will also receive **protection from retaliation** under the law, as they are covered under Sarbanes-Oxley (Section 806 provides job security and financial damages if retaliation is enacted).

Although it is in its infancy so far — it is reported that in the first seven weeks of implementing the whistle-blower programme under the Dodd-Frank Act, only 13 of 334 eligible tips involved alleged violations of the Foreign Corrupt Practices Act, according to the SEC Annual Report — the impact in the longer term on reported incidents of corporate corruption could be extremely large due to the directly incentivised nature of the rewards.

### ■ Multi-jurisdiction fines – an illustration: Aon Ltd

*"The FSA does not consider that Aon Ltd's conduct was either deliberate or reckless. However, Aon Ltd was, or should have been, aware of the risks associated with making payments to Overseas Third Parties to obtain or retain business" <sup>18</sup>*

Increasingly there is **cross-border co-operation** amongst law enforcement agencies, especially against multinational corporations where the nature of the corruption itself is likely to involve several parties and agents across multiple territories. This heightens risk for investors in global companies. Alstom, Siemens and the majority of all cases with USD100m+ penalties have involved multi-jurisdictional investigations but this is not restricted to the largest of cases or those initiated by the US FCPA, as the Aon example shows.

#### AON INSURANCE: PROSECUTION IN THE US AND THE UK

US	UK
Parallel US case finalised after UK settlement: USD16m settlement: (Non Prosecution Agreement) in Costa Rica – false expenses repaid directly in cash as bribes	UK Financial Services Authority (FSA) fined Aon GBP5.25m for payments to multiple overseas third parties, specific suspicious payments of USD2.5m and USD3.4m uncovered
USD11.4m disgorgement (returning profits for premiums on policies gained directly through bribes),	Charge: failings in its anti-corruption systems between 2005-2007
USD3m in prejudgement interest - i.e., an award for interest accrued for illegal activity prior to the final verdict being issued	30% discount on the above fine for co-operation and early settlement
USD1.76m fine	
Charge: failure to keep accurate books and records regarding benefit of foreign officials, failure to maintain and devise internal controls	

Source: SEC, DoJ, FSA

### III – The Cheuvreux investor guide to anti-corruption

Three areas are commonly identified as increasing corruption risk especially when there is overlap between them:

- Operating in regions where bribery is common and seen as a "way of doing business": we take an in depth look at the geographic risk implications in a separate section
- Exposure to high-value government contracts: historically these kinds of contracts have been and will continue to be vulnerable to illicit payments
- Using intermediaries or agents – especially in procurement processes

**Certain sectors are implicated in all the above and therefore are more intrinsically at risk – we take a look at such sectors in the final section of this report.**

#### ■ The mechanics of bribery: How it works

We mark the main mechanisms by which bribery occurs before outlining best practices to prevent acts of corruption:

- **Direct cash payments** ("stuffed briefcases") – these can originate from "slush funds" or generic cash accounts
- **Donations to charities and foundations** that are later diverted or on whose boards' recipients or contract decision-makers sit. Sometimes used to sponsor in-kind bribes such as holidays and travel unrelated to business. The Wall Street Journal (which we highlight is a competitor of Pearson owned media) carried a story alleging the non profit arm the Pearson Foundation was under investigation by the New York State Attorney in 2011 of misusing its funds to improperly influence Pearson Education clients<sup>19</sup>.
- **Commissions** concealed as bribes where no actual business activity has taken place.
- A **third party** such as a marketing agent accepts a commission/success fee; the third party may then pass funds on to relevant public-sector officials or private-sector decision-makers to secure contract approval. Tognum AG was accused of using this mechanism in a South Korea joint venture<sup>20</sup>.
- **Contract price inflated** with the excess used as the bribe component. This became standard practice for a large number of companies in the UN's Oil-for-Food Programme in Iraq.
- **Falsified expenses or large expenses with little or no business content.** This technique has been used in the pharma industry to encourage doctors to prescribe certain drugs.
- **Offshore payments** made to reduce traceability, and tax implications are extremely common in bribe payments.

**In most cases, the major source of risk lies with "Associated Persons" that enable the above mechanisms to be used.** A company needs to ensure that its conduct policy is clearly extended to apply to such persons. Corruption is usually impossible without the full chain extending beyond employees to third-party activities. "Associated Persons" are defined as employees, agents, consultants, contractors, suppliers, joint venture partners (recent JV cases include ThyssenKrupp and Siemens), subsidiaries and other persons within any business process.

**Bribing techniques vary greatly in their sophistication**

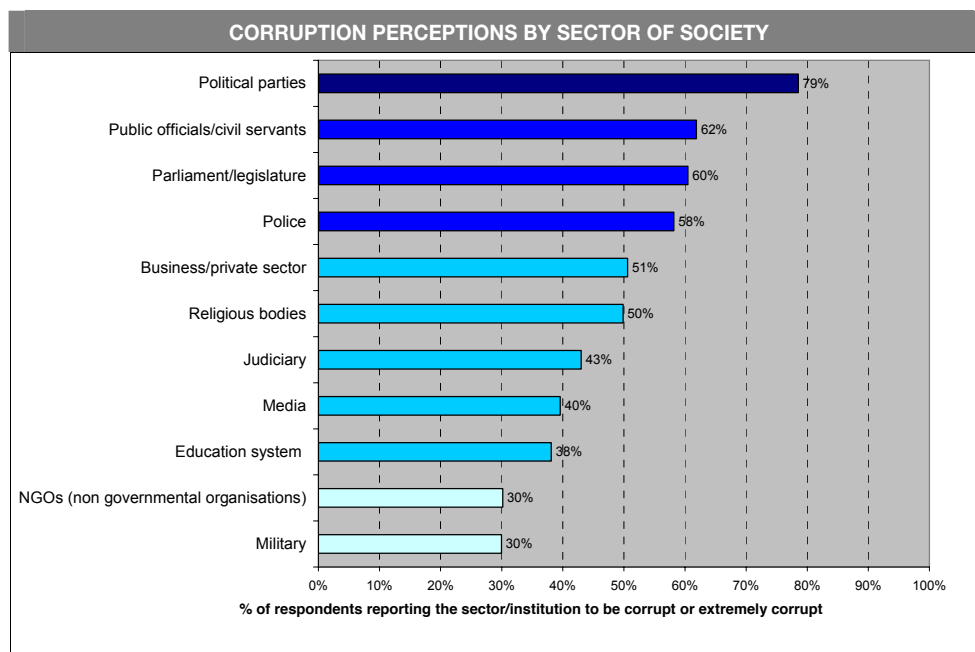
**Due diligence should focus on "Associated Persons"**

### Bribe payments tend to flow upwards in the power chain

## Politicians and heads of state as bribe recipients

The US Securities and Exchange Commission's (SEC) complaint against Siemens specifically mentions how the company's Argentinean unit "paid scores of millions of dollars in bribes intended for top government officials in Argentina, including two presidents and cabinet ministers"<sup>21</sup>. We note that within the mechanisms of bribe payments, the final recipients within a complex chain may be none other than a head of State. A major argument put forth by NGOs is that these illicit capital flows stunt growth, particularly in less developed countries, where the revenues are most needed for investment.

Furthermore, the NGO Transparency International establishes a survey that shows that **politicians are regarded as the group most likely to receive bribes**. In fact, within the banking system, those known as "Politically Exposed Persons" are considered to have heightened compliance risk regarding bribery and money laundering. They are defined as those with publicly-visible positions of senior authority within governments, or others with close connections to such people.



Source: Transparency International, 2010 Barometer

We note that while companies may not deal with heads of state directly, the risk of illicit payments grows significantly when business takes place in autocratic or undemocratic regimes, as the structure of companies and the intermediaries involved are more likely to have links to top government.

The table below lists heads of state and their records on embezzlement – a significant part of which comes from the corrupt extraction of revenues and bribes for authorising contracts and licences. However, corruption is not limited to controversial leaders such as those below; a number of democratically-elected leaders within Europe and developed economies have also faced allegations of corruption and embezzlement.

### ESTIMATED EMBEZZLEMENT BY HEADS OF STATE

Head of State	Position	Funds (USD)	Period
Mohamed Suharto	President of Indonesia	15-35bn	1967-1898
Ferdinand Marcos	President of the Philippines	5-10bn	1972-1986
Mobutu Sese Seko	President of Zaire	5bn+	1965-1997
Sani Abacha	President of Nigeria	2-5bn	1993-1998
Slobodan Milošević	President of Serbia/Yugoslavia	1bn	1989-2000
Jean-Claude Duvalier	President of Haiti	300-800m	1971-1986
Alberto Fujimori Fujimori	President of Peru	600m	1990-2000
Pavlo Ivanovych Lazarenko	Prime Minister of Ukraine	114-200m	1996-1997
Arnoldo Alemán	President of Nicaragua	100m	1997-2002
Joseph Estrada	President of the Philippines	78-80m	1998-2001

Source: Transparency International Global Corruption Report 2004

As some of the countries in the list above suggest, this phenomenon may be **amplified but is not exclusive to those countries with a predominance of extractive industry exports**.

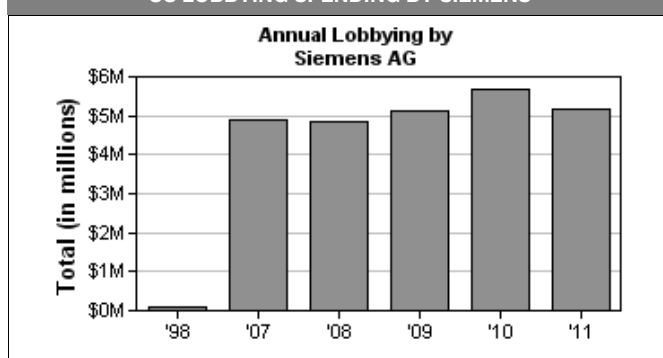
### Lobbying – A grey area

Whilst lobbying or the influencing of government can hold a constructive place in the legislative process and needs to be separated from bribery as its scope is legal, it is rife with ethical conflicts even when companies are fully compliant with laws.

The conflicts lie in the ability of corporates and industry bodies to hold undue influence within the political arena and do so without transparency.

While the US has the best enforcement in pursuing international bribery cases, its own legislation allows a significantly wider scope for lobbying involving both private and corporate entities. Washington DC-based CtW Investment Group recently criticised Siemens for its involvement with the US Chamber of Commerce, which lobbies against tightening of the Foreign Corrupt Practices Act (FCPA) regulations<sup>22</sup>. Siemens USA chief executive Eric Spiegel holds a seat on the US Chamber of Commerce's board.

#### US LOBBYING SPENDING BY SIEMENS



Source: Opensecrets.org

#### SIEMENS EU LOBBYING

Financial Year: 10/2010 - 09/ 2011	Amount (EUR)
Estimated cost to Siemens directly related to representing interests to EU institutions	3,888,241
Funding received from EU in prior year:	
Procurement	1,226,1787
Grants	1,210,3815

Source: Europa Transparency Register

The chart above shows total lobbying expenditure for Siemens of USD5.1m in 2011, against USD1.195m for Alstom or USD26.34m for US giant General Electric.

As we can see above – within the EU a Lobbyist Register exists but it is voluntary and has been widely criticised by NGOs such as Friends of the Earth and Transparency International for the lack of visibility over corporate involvement and their financial spend.

The International Corporate Governance Network (ICGN) issues best practice guidelines for corporates on political lobbying and donations<sup>23</sup>:

**Legitimate:** serving the interests of the company as a whole and its investors;

**Transparent:** clarity on policy, decision-makers, and goals and reasoning on changing public policy. Should include both direct and indirect costs of political activity. Lobbyist firms retained to be publicly disclosed;

**Accountability:** shareholders hold the board accountable, and the board in turn holds managers involved in lobbying accountable;

**Responsibility:** Overall public welfare taken into account and not damaged at the expense of special interest groups.

Direct monetary donations to political parties carry value limits and are widely regulated in most countries – requiring a far higher degree of mandatory public declaration than lobbying.

## ■ Prevention is better than cure: The Anti-Corruption Systems Toolkit

Below are the key indicators of an effective anti-corruption culture within a company. The items below should be well documented as part of an overall compliance plan. The key recipients should be identified via a comprehensive risk assessment of all employees and third parties with distribution effected via training. Critically, a robust compliance plan with all these elements will contribute to **prevention of and early detection of potential violations, thus minimising reputation impact and the possibility of litigation.**

### CONSTITUENTS OF AN IDEAL ANTI-CORRUPTION SYSTEM

Item	Characteristic
Whistle-blowing	Anonymous, maintained externally, audited by third party, open to non employees (i.e. suppliers & business partners), with non retaliation policy
Facilitation payments (routine, usually small payments to government officials to expedite processes already obliged to perform)	Facilitation payments prohibition policy. Allowed only in case of Health or Safety emergency where it must be documented and preventative measures introduced.
Risk assessment	Full in depth risk assessment of processes, services and regions most at risk. Due diligence in M&A
Zero tolerance	Public declaration of zero tolerance, ideally by a signed CEO statement
Third parties	Application of policy to all associated parties and contractual obligations to third parties to ensure anti-bribery provisions. Specific Anti-Corruption Checks, Guidelines & Training for areas such as Anti-Cartel, Taxation, R&D and HSE and other relevant areas if found to be at risk of the use of bribery through requirement to use third parties and official authorisations
Top-level commitment	Anti-corruption statement publicly signed off by CEO
Board-level accountability	Designated person responsible for anti-corruption systems
Training	Global application of compulsory training including e-learning in multiple languages for the most relevant departments and geographical regions
Operational policy	Clear policy with suggested price limits on gifts, hospitality and entertainment, charitable donations, political donations. Specific implementation programmes for acquisitions and subsidiaries. Policies and systems monitored and revised as necessary
Clear-reporting lines	Down from board level, via for example the Chief Compliance Officer, to employees
Investigation, enforcement & incentives	Regular checks and audits and for all reported cases, Disciplinary measures effected. Incentives in variable pay to include element based on ethics criteria
Industry-specific guidance for each business line	Key business units given differentiated guidance where necessary according to business risk
Supplier selection process	Suppliers obliged contractually to uphold anti-bribery due diligence. Dropped if refuses to sign

Source: CA Cheuvreux

## The viewpoint of top management

### Senior-level commitment makes the difference

Cases where bribery is shown to be widespread in nature (see Siemens for allegations of a systematic use of "slush funds") can be correlated to a lack of senior-level visibility promoting a policy against corruption.

**Therefore top-level commitment or the "tone from the top" can be a key indicator** of a company's confidence in its own policies as a proactive measure to prevent corruption, provided it is not declared as an emergency measure or reactive response to contain fallout from a bribery scandal. If the board and C Level executives publicly declare their support for anti-corruption indicatives, we believe it can be a driver to encourage all employees to follow suit. Actual and potential stakeholders may also interpret such a move as a signal for the standards expected of them especially if accompanied by contractual obligations to follow anti-bribery procedures. The more senior the support for such indicatives, the stronger the confidence in the efficiency of the implemented systems is likely to be. **We emphasise that top-level support is of heightened value as a proactive measure rather than being used after the event of corruption allegations appearing in the media or indeed court judgements.**

## The message should be simple

### Zero tolerance is best practice

Any company that firmly and publicly declares that all forms of bribery and corruption are outlawed in all territories is likely to be better positioned to drive a corporate culture away from behaviour that poses risks to the company. One example involves corporate policies where facilitation payments are allowed in certain regions (where they are not illegal) up to fixed amounts if declared and accounted for. The ideal message is that no exemptions will be possible except in an extreme case of urgent threat to health and safety of the employees, despite the fact that the payments may not be explicitly illegal in some countries of business.

## Effective whistle-blowing is the key tool

### In our view, robust whistle-blowing schemes are critical

We believe that a whistle-blowing scheme - as long as it is independent, externally audited and allows anonymity - is a very strong anti-corruption system and the major indicator of a company's commitment to this area. In the US, the Sarbanes-Oxley legislation requires companies to allow anonymous employee reporting of incidents - under the responsibility of the audit committee (the recent Dodd-Frank Act also incentivises direct whistle-blowing to the SEC through monetary rewards, under certain conditions discussed in the previous section.) The UK Combined Code protects whistle-blowers but it is only a recommendation that UK audit committees have such schemes.

An ideal whistle-blowing scheme will be externally maintained. Though many hotlines use a third party for reporting complaints these are usually channelled back to the company (often internal audit will receive the complaints). It is still rare for a whistle-blowing scheme to be entirely run externally - but for complex global companies with geographically diverse supply chains and sales functions this is best practice.

### IDEAL WHISTLE-BLOWING POLICY ELEMENTS

Anonymity	Allow anonymous reporting
External	Be externally maintained at both reporting level and follow up; to prevent major and systematic cases from being covered up
Audited	Audited by independent external agencies
Open	Be open to non employees i.e. allow third parties and suppliers to report
Non-retaliation	Publicly-disclosed non-retaliation policies
Transparency	Produce some relevant elements of public reporting on usage and enforcement statistics i.e. % calls by subject and number and nature of follow-up enforcement

Source: CA Cheuvreux

## Facilitation payments should be prohibited

## Proportionate procedures

We note some countries may have tighter legislation over the implementation of whistle-blowing programs, which in certain cases may reflect that anonymous whistle-blowing is less culturally acceptable. The French CNIL legislation which covers data protection restricts the use of whistle-blowing schemes in the country to the main areas of bribery, corruption, and financial fraud unless special permission is granted to extend the schemes.

### Facilitation payments policy

Facilitation payments are small payments made to government officials to speed up or enable processes to which the bribe payer is ordinarily entitled. These payments may be treated separately in the bribery legislation of some countries. Notably, the UK Bribery Act outlaws these practices very clearly, thus differentiating itself from US FCPA legislation. It seems unlikely that the UK would pursue companies over a handful of isolated incidents but if a corporation is found to have systematically authorised these payments it would be at risk. If there is evidence of facilitation payments having been authorised alongside more serious systematic bribery, involving procurement for example, it could count badly against the company in the litigation process under the UK Bribery Act.

**Best practice is to ban facilitation payments altogether**, while explaining carefully what these are to all relevant employees, through internet, intranet and other information distribution channels. The only exemptions should be the threat to the health and safety of employees. Sound Code of Ethics policies may explain that facilitation payments can open the way to larger undue payments. We also note that filing facilitation payments as legitimate accounts can cause significant risk legally.

We note that facilitation payments are also prohibited in certain other countries including Germany and France.

### Mid caps still at risk even with lower requirements

Though large cap multinationals with UK business are clearly exposed to the new Act, **mid cap companies** without clearly documented systems and procedures will also be at risk as they may not have invested enough in improving their anti-corruption systems - and are more at risk than previously under the remit of the UK Bribery Act.

Although the penalties imposed may be smaller the costs of investigation and compliance have a more significant capacity to weigh on mid caps and cause larger disruption than that experienced by the largest multi nationals.

Mid caps following expansion strategies in riskier territories should also concern themselves with strong anti-corruption systems as they can face the same bribery risk scenarios as large caps regardless of their smaller size.

If holdings in mid cap companies are sizeable, the investor should also be aware of the increased future risk of being requested to return dividends that are the proceeds of bribery (where sufficient influence and connection from investor is present - see the Mabey case on page 26).

Bloomberg data for a sample of 293 European companies covered by CA Cheuvreux across five sectors (energy, materials, capital goods, pharma & biotech, and insurance) shows that 59% of companies with a market cap of less than EUR6bn have a publicly disclosed mention of bribery within their business ethics policy vs. 83% for those with a EUR6bn+ market cap.

Both UK law and the US FCPA (Foreign Corrupt Practices Act) would not expect the same level of anti-corruption systems and disclosure as for large caps, however medium-sized companies have been prosecuted in the past, and we would expect this to continue.

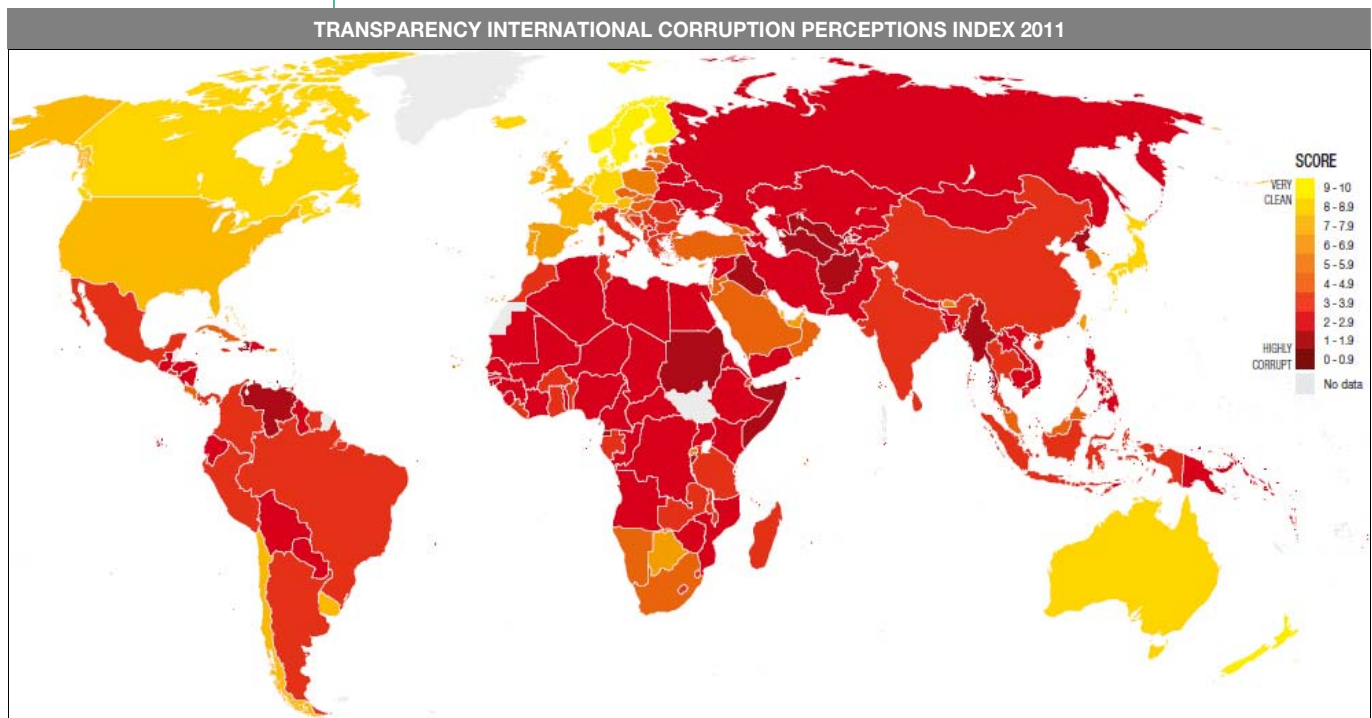
### Anti-corruption guidance and voluntary initiatives

A number of frameworks exist to give guidance on relevant best practice, these vary in scope, and we present only some major ones below:

- **The UN Global Compact (UNGC):** Principle 10 covers bribery and corruption through the goal: "Businesses should work against corruption in all its forms, including extortion and bribery." Signatories are required to present reporting on the topic.
- **Partnering Against Corruption Initiative (PACI):** Part of the World Economic Forum, this initiative provides specific sets of tools including detailed guidance, self-evaluation, and benchmarking. CEOs have endorsed the programme and global companies such as ABB, Alcatel Lucent and Siemens have signed.
- **Extractive Industries Transparency Initiative (EITI):** Specifically for oil, gas and mining industries, the EITI is a multi-stakeholder group including companies, governments and NGOs that pushes for full revenue declarations by both governments and companies, which can be reconciled on a signatory country level.
- **TI Business Principles for Countering Bribery:** This Guidance contains an overall anti-bribery code applicable across multiple company settings with models of good practice.

### ■ Here, there and everywhere: assessing geographic risk

The map below shows perceptions of corruption on a country-by-country basis as per results of systematic surveys. Based on the Corruptions Perceptions Index (CPI), which is carried out by Transparency International, the map illustrates the perception of the frequency of bribes paid by region.



Source: TI CPI 2011

### Lax regulation in developed countries and bribe recipients in developing countries

Emerging territories score lowest but corporate bribery is a global phenomenon. Lax regulation and enforcement in developed countries may contribute to the use of bribes by developed country companies in developing countries. A 2011 Transparency International (TI) report on the status of legal frameworks and the implementation of OECD guidelines was pessimistic. It showed that progress has not only been slow but has been reduced in OECD countries as a whole:

*"This is the first time in the seven years TI has been reporting on the OECD anti-bribery Convention that no progress has been made in the number of countries enforcing the Convention's prohibition against foreign bribery."* TI Progress Report on Enforcement of the OECD Countries.

TI's findings are consistent with the OECD's own review, which reported that only five parties to the Convention sanctioned individuals or companies in the past year.

An area where data is sparse is **the effect of Asian and Latin American takeovers** of European and American companies. It remains to be seen if a trend emerges as to a weakening of the target firms' anti-corruption culture or a strengthening of the acquirer's such culture.

### Key results of the Transparency International OECD progress report

**Only three countries** are categorised as having an adequate legal framework for enforcement measures: the US, the UK and Israel. Given the global trade volumes with the US, the large number of multi national companies listed with the SEC and the quantity of cases enforced and subsequent penalties pursued we reiterate it the Department of Justice (DoJ) and Securities and Exchange Commission (SEC) agencies of USA that presents the largest anti-corruption authorities.

Note that even the countries in the Active Enforcement category may not be deemed as satisfactory in terms of their legal framework. Similarly, **although Italy is classed as an active enforcer, it was ranked 67** (Greece was the only western European country to rank lower) perhaps showing that the scope of its problems require further enforcement still.

Although both the TI Bribe Payers and Corruption Perception Indices show that bribes are perceived as being most common in emerging markets, the OECD country anti-enforcement status table, which measures the number of cases and the sanctions imposed, shows that a number of countries perceived as having less corruption (according to TI Corruptions Perceptions Index) in bold, have little or no enforcement of cases.

### Poor legal frameworks outside the US and UK with few countries actively enforcing

### Despite developed economies performing well in the Bribe Payers Index, several countries are categorised as having Little or no Enforcement

#### TI BRIBE PAYERS INDEX

Country Group	Score
Sub-Saharan Africa	55.80%
Middle East and North Africa	36.30%
NIS+	32.00%
Latin America	23.20%
Western Balkans + Turkey	19.50%
Asia Pacific	11.30%
<b>EU+</b>	<b>5.00%</b>
North America	4.60%

Source: TI Global Corruption Barometer

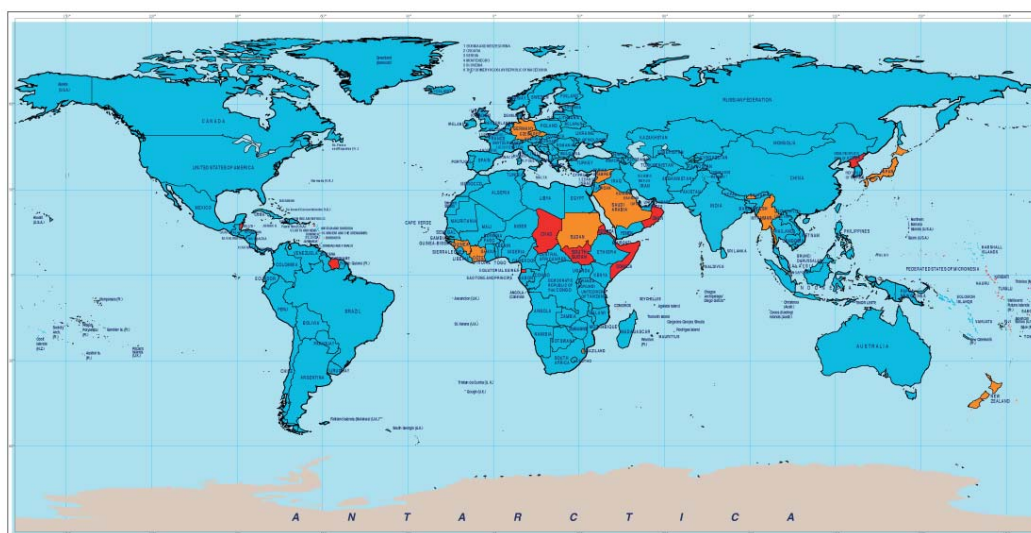
## OECD COUNTRY ANTI-CORRUPTION ENFORCEMENT STATUS

Category	Percentage world trade	Countries
Active Enforcement	30%	Denmark, Germany, Italy, Norway, Switzerland, UK, US
Moderate Enforcement	20%	Argentina, <b>Belgium, Finland, France, Japan</b> , Korea (South), <b>Netherlands, Spain, Sweden</b>
Little or No Enforcement	15%	<b>Australia, Austria</b> , Brazil, Bulgaria, <b>Canada</b> , Chile, Czech Republic, Estonia, Greece, Hungary, <b>Ireland</b> , Israel, <b>Luxembourg</b> , Mexico, <b>New Zealand</b> , Poland, <b>Portugal</b> , Slovak Republic, Slovenia, South Africa, Turkey

Source: TI 2010 Progress Report, Enforcement of the OECD Anti-Bribery Convention

### GERMANY & JAPAN NOT YET STATE PARTIES IN THE UN AGREEMENT

## UNCAC Signature and Ratification Status as of 06 January 2012



- States Parties
- Signatories
- Countries that have not signed or ratified the UNCAC

**Signatories: 140**  
**States Parties: 159**

Source: UNCAC

We note also that Germany and Japan<sup>24</sup> are two major trading nations that have not yet become State parties to the United Nations Convention against Corruption. However, the G20, which comprises 19 countries (including Japan) and the European Union, has a working group on corruption, it therefore includes several non-OECD countries and also works toward an Anti-Corruption Plan for its member countries. Ultimately we emphasise that there are a variety of international treaty frameworks and global plans which are steadily being strengthened.

**As two of the largest and fastest-growing trade partners, China and Russia are cause for concern**

### TRANSPARENCY INTERNATIONAL BRIBE PAYERS INDEX, 2011

Rank	Country	Score	Rank	Country	Score
Below Average			Above Average		
1	Netherlands	8.8	14	Brazil	7.7
1	Switzerland	8.8	15	Hong Kong	7.6
3	Belgium	8.7	15	Italy	7.6
4	Germany	8.6	15	Malaysia	7.6
4	Japan	8.6	15	South Africa	7.6
6	Australia	8.5	19	Taiwan	7.5
6	Canada	8.5	19	India	7.5
8	Singapore	8.3	19	Turkey	7.5
8	UK	8.3	22	Saudi Arabia	7.4
10	USA	8.1	23	Argentina	7.3
11	France	8	23	UAE	7.3
11	Spain	8	25	Indonesia	7.1
13	South Korea	7.9	26	Mexico	7
	<b>Average</b>	<b>7.8</b>	27	<b>China</b>	<b>6.5</b>
			28	<b>Russia</b>	<b>6.1</b>

Source: Transparency International BPI 2011

The above BPI table shows results to the survey question "*How often do firms headquartered in (country name) engage in bribery in this country?*" ranked by 28 leading economies.

Although there are a great many countries below Russia and China in the separate Corruption Perceptions Index (CPI), the worry is that the volume of trade taking place with Russia and China, and its expected growth, poses an increased risk. In Russia alone, 15-40% of GDP is estimated to be accounted for by bribes. We note that overall anti-bribery legislation has been tightened with regards to penalties in both Russian and China in 2011 and that **foreign companies in these territories are liable** if found to have paid or authorised bribes.

### Don't be deceived... domestic risk is as big as ever

The focus on operations in emerging markets can be deceptive, as the true impact of corruption scandals is felt to the same degree regardless of where they originate. The recent case involving News Corp is a paradigm. Bribes were allegedly paid to police in order to assist in "phone hacking" – although some bribes allegedly had taken place in the US, the major allegations surrounded UK-based wrongdoing: i.e. British police bribed by domestic journalists for the largest selling tabloid newspaper in the country.

### ■ M&A risk: The role of due diligence

■ **Smith & Nephew** (UK based and Europe's largest medical device manufacturer) acquired a Swiss company for approx EUR500m in 2008. Unacceptable sales practices i.e., bribery uncovered after post-acquisition due diligence<sup>25</sup>.

■ **Kraft Foods' acquisition of Cadburys** led to an SEC subpoena requesting info on "dealings with Indian governmental agencies and officials to obtain approvals."<sup>26</sup>

■ **Lockheed Martin's** tender offer for Titan Corporation had to be cancelled and the target firm went on to pay a USD28.5m settlement against allegations it paid a USD2m bribe to the President of Benin for his election funds. It also had to implement tough compliance systems and external monitoring<sup>27</sup>.

## Insurable losses?

## Corruption risks often emerge from and are magnified by poor corporate governance

■ **Latin Node Inc.** was found by acquirer eLandia International Inc. to have potentially engaged in bribery in Yemen and Honduras after the acquisition was completed. The target company was charged under the FCPA and the entire investment was subsequently written off two years later<sup>28</sup>.

■ **We also note that acquisitions can be affected as fallout from scandals involving alleged bribery. News Corp.** dropped its bid for BSkyB in July 2011 and the UK broadcast regulator OFCOM is said to be examining the "fitness" of News Corp. to hold a broadcast licence following recent phone hacking and related bribery charges<sup>29</sup>. Business strategy can thus also potentially be disrupted as a result of bribery related allegations.

**In particular however companies pursuing aggressive M&A strategies in Asia (and Russia) may benefit from active due diligence and anti-corruption systems specifically implemented with the risk profile of target firms in mind.**

### Are companies covered when management pay bribes?

Most large companies will have **Directors and Officers insurance** or D&O. This is insurance cover for defence costs as a result of non-criminal prosecutions for commercial activity. The extent of cover for litigation arising from bribery is variable and the definitions of "loss" incurred can be highly complicated. Some policies are reported to specifically exclude all activity falling under the UK Bribery Act. Others require an additional premium for cover. However a major concern is likely to be **investigation costs, which may quickly outstrip any benefit limits due to the millions required for legal costs**. What is relevant is that underwriters would likely carry out their own risk assessments and look carefully at a company's risk profile when assigning cover with the possibility that the premium would be denied or elevated in price in the absence of acceptable anti-corruption systems.

### Why corruption can be a corporate governance issue

Ineffective corporate governance can increase a company's exposure to corruption risk through an inability to monitor overall control structures. Companies such as News Corp., which have been accused of bribery, have had a history of corporate governance conflicts that ties in directly to their ability to implement and enforce effective anti-corruption systems.

Where minority shareholders feel that they are not adequately represented there may be issues with the overall control structure of the boards of companies due to the dominant influence of some shareholders through voting rights. If this is the case there may be very little room for challenges to management, from the daily operations of the company, upwards.

Corporate governance is also an issue when companies make acquisitions that they are unable to adequately influence, despite their own anti-corruption systems being sound. In the Telecommunications chapter we note TeliaSonera and its experience with TurkCell where governance concerns were already central before corruption allegations emerged against TurkCell in Kazakhstan.

### ■ Food for thought: could shareholders be the next target?

A recent UK case involving Mabey Engineering Holdings sent an initial signal to investors on the possible long-term direction that prosecution may take. In this example, the major investor receiving the dividends — a single parent company — was forced to repay dividends received as direct proceeds from corrupt activities from a company it held. Whilst the pursuit of multiple individual institutional shareholders may still be a long way off — due to the impracticality of assigning specific recovery amounts to multiple relevant investors within complex financial markets — there are implications for investors in the

long run. Investor due diligence and commitment is more important than ever, and the penalty enforced shows that shareholders under certain circumstances (particularly where they have operational leverage over their investments) should not expect in the long term to be immune from direct pursuit by authorities even if they have indirectly, unknowingly, benefited from the proceeds of corruption through dividend earnings.

### Case background:

Maybey & Johnston was found guilty in Sept 2009 of breaching UN "Oil-for-Food" sanctions and paying bribes of GBP831,878 for contracts worth GBP44.4m. The company was fined GBP6.6m, with individuals fined for breach of UN sanctions<sup>30</sup>.

Mabey Engineering Holding agreed to repay a GBP131,201 dividend payment received from Mabey & Johnson for infrastructure construction activity in Iraq. Two former executives received jail terms.

*"[...] shareholders and investors in companies are obliged to satisfy themselves with the business practices of the companies they invest in. This is very important and we cannot emphasise it enough. It is particularly so for institutional investors who have the knowledge and expertise to do it. The SFO intends to use the civil recovery process to pursue investors who have benefited from illegal activity. Where issues arise, we will be much less sympathetic to institutional investors whose due diligence has been lax in this respect."*

– Richard Alderman, UK Serious Fraud Office

### Self-referral and self-investigation

For Mabey & Johnson, the case was self-referred to the UK authorities, and the Serious Fraud Office allowed the company to self-investigate. (This use of self-investigation is also evident in several US cases). The cooperation shown by the company and its willingness to come forward with evidence against itself meant that ultimately the SFO issued a statement in favour of the outcome and went some way to mitigate reputational damage.

But whilst self-referral and investigation are advantageous in terms of overall cost savings and a more favourable and quicker settlement, the costs are still substantial particularly when taken as a ratio to the penalties awarded.

**Self-investigation is preferable but the costs may ultimately be higher than any penalties received**

## IV – Most-exposed sectors

*Though bribery is a potential risk to any business in any sector, certain industries through the nature of their operations are more highly exposed to corruption risks.*

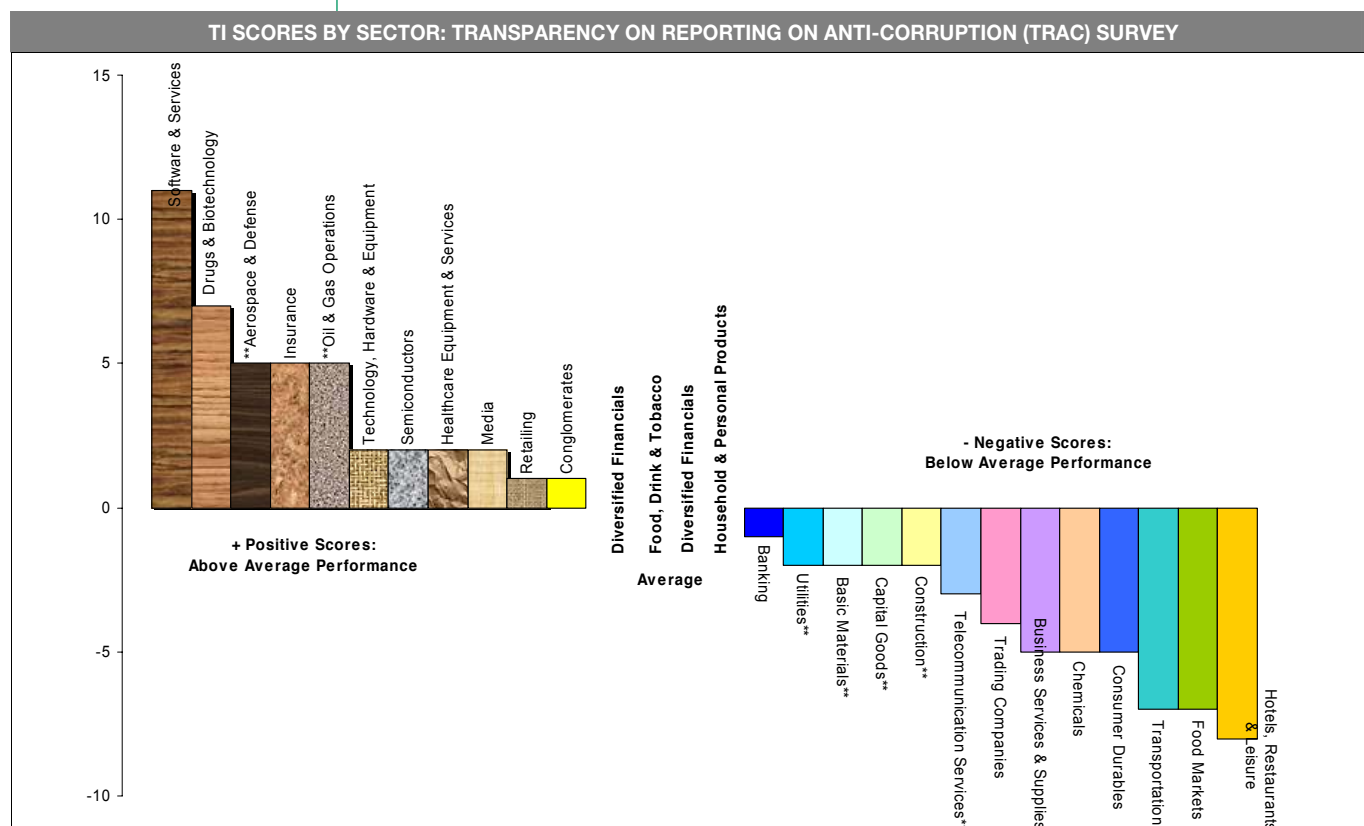
### ■ General risk characteristics

The industries that score highest in surveys of perceived corruption risk will typically:

- Involve bidding for high-value contracts
- Have a large degree of interaction with governments
- Depend on public officials for day to day operational running
- Operate in regions where bribery is more openly ingrained

The table below presents the TRAC Index created by Transparency International. This measures companies across sectors on their reporting performance and anti-corruption systems, where the highest scoring sectors are perceived to be the "cleanest", and starred sectors are classified as high risk by the NGO. The results show that some of the sectors scoring well are those that are the most notorious in terms of corruption scandals, e.g. defence and oil and gas. This can be attributed to the fact that these same industries have implemented systems to combat the risks they face, and would thus score better than other high-risk industries, such as capital goods or utilities, where companies have not implemented anti-corruption measures on the same scale across the sector.

## ■ Sector comparisons: A relative view



## SECTOR SCORES FOR CORPORATE REPORTING

Above		Average		Below	
Software & Services	28	<b>Average score</b>	<b>17</b>	Banking	16
Drugs & Biotechnology	24	Food, Drink & Tobacco	17	Utilities**	15
Aerospace & Defence**	22	Diversified Financials	17	Basic Materials**	15
Insurance	22	Household & Personal Products	17	Capital Goods**	15
Oil & Gas Operations**	22			Construction**	15
Technology, Hardware & Equipment	19			Telecommunication Services**	14
Semiconductors	19			Trading Companies	13
Healthcare Equipment & Services	19			Business Services & Supplies	12
Media	19			Chemicals	12
Retailing	18			Consumer Durables	12
Conglomerates	18			Transportation	10
				Food Markets	10
				Hotels, Restaurants & Leisure	9

\*\*Starred sectors are classed as high risk

Source: TI: Transparency in Reporting on Anti-Corruption 2009

We also note Transparency International's finding that looks at perceptions of sectors regarding the frequency of bribes to public officials and vs. the more high-level "state capture" or manipulation of the political system. This could include illegal bribes to politicians but also legal activities such as lobbying, which are perceived to have an undue influence without adequate transparency.

**BRIBERY OF PUBLIC OFFICIALS VS. MANIPULATION OF THE POLITICAL SYSTEM ("STATE CAPTURE")\***

Sector	Bribery of public officials	State Capture	Differential
<b>Public works contracts &amp; construction</b>	<b>5.2</b>	<b>5.6</b>	<b>-0.4</b>
Real estate & property development	5.7	5.9	-0.2
Oil & gas	5.9	5.7	0.2
Heavy manufacturing	6	6.1	-0.1
Mining	6	5.8	0.2
Pharmaceutical & medical care	6.2	6.2	0
Utilities	6.3	6.5	-0.2
Civilian aerospace	6.4	6.5	-0.1
Power generation & transmission	6.4	6.5	-0.1
Forestry	6.5	6.7	-0.2
Telecommunications & equipment	6.6	6.5	0.1
Transportation & storage	6.6	6.7	-0.1
Arms & defence	6.7	6.4	0.3
Hotels, restaurant & leisure	6.7	7	-0.3
Agriculture	6.9	7.1	-0.2
Light manufacturing	6.9	7.2	-0.3
Information technology (computers & software)	7	7	0
<b>Banking &amp; finance</b>	<b>7.1</b>	<b>6.6</b>	<b>0.5</b>
Fisheries	7.1	7.1	0

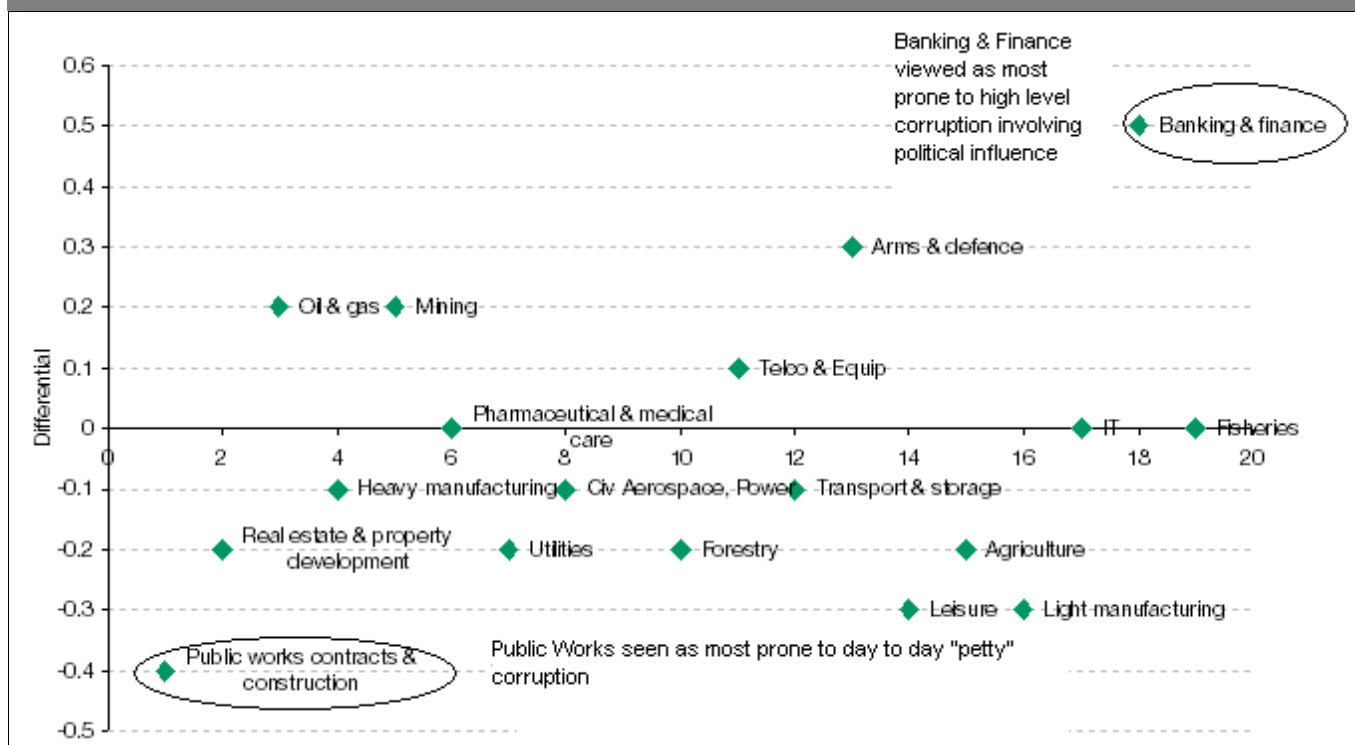
\*Possible scores range from 0 to 10, with 0 representing the view that 'bribes are almost always paid' and 10 that 'bribes are never paid' by a sector.

Source: TI BPI 2008

The key findings relate to the sectors at the extreme ends of the differential scale:

- Public works & construction: the perception is that operational or day-to-day bribery is higher than political bribery.
- By contrast, the banking sector is perceived as having less day-to-day bribery but significant political influence.

## BRIBERY OF PUBLIC OFFICIALS VS. UNDUE INFLUENCE ON THE POLITICAL SYSTEM



Source: TI bpi 2008

The above chart alerts us to **the differing types of corruption** as perceived to be taking place on a sector basis. Public Works is seen to be most prone to daily acts of bribery, smaller in scale but more frequent. The banking and defence sectors show the greatest perception of "state capture" or higher level corruption including lobbying.

## ■ Company risk mitigation profiles

In this study we look at four major sectors that are exposed to corruption. We examine major companies and analyse their risk mitigation profiles. These profiles are based on three factors:

- 1) **Specific areas of publicly declared policies** which we think are critical in preventing acts of corruption. These include whistle-blowing, reporting structures, training, facilitation payments and zero tolerance.

Transparency from companies can show greater confidence in the firms' own ability to manage anti-corruption systems. We consider adherence to the UN Global Compact (UNGC) to be one factor in increasing a company's ability to manage corruption risks, as Principle 10 requires commitment from the company to counter bribery and some element of increased transparency may ensue.

Public Reporting of anti-corruption policies as a whole also sends a clear signal to both actual and potential employees, suppliers and all stakeholders. We note, however, that even if a company has not declared a policy on anti-corruption, strong internal systems nonetheless may still exist.

- 2) **Current allegations that have received media attention.** We take full note that some press allegations may not materialise into judicial cases. However, as news flow they are critical for investors. Companies with the strongest publicly declared anti-corruption systems will in our view be best positioned to handle incorrect allegations and mitigate both the reputation and legal concerns that arise.
- 3) **Regions of revenue according to their risk,** based on Transparency International ratings. Countries included in the "Revenue Reporting for Higher Risk Regions" fall below the Best Performing 20 Countries in the 2011 Transparency International Corruptions Perceptions Index<sup>31</sup>. Geographic Segment Reporting can vary widely from company to company so the figures below are also an indication of the transparency of revenue declarations. We note that even for the companies with strongest publicly declared anti-corruption systems, geographic exposure can present residual risk despite the best efforts of companies to actively counter corruption. Geographic revenues are sourced from Bloomberg data.

## ■ Reminder of our approach to sources

We neither confirm nor deny allegations reported by the media in including them in this report. ESG analysis requires us to consider all stakeholders and media sources in order to assess potential reputation risk for investors. In this report we use a variety of journalistic sources, including local ones where we feel they reflect a relevant area of risk. Often allegations will surface long before evidence is objectively presented or any official announcements either by authorities or even less so by companies themselves. They are however of central interest to investors as news flow, and critical within the context of reputation risk that we examine.

All sources mentioned as allegations are systematically referenced in the Notes (from page 67) in order to be traceable.

## V – Telecommunications

### RISK PROFILE FOR THE TELCOS SECTOR

Telecommunications	
Risk level	High
Key factors	Foreign licensing process, holdings companies
Well positioned	Telefonica, Vodafone, KPN

Source: CA Cheuvreux

Major themes in the industry have been in relation to *licensing contracts* with national governments, bribery of *public officials*, and *bribery to enforce collusive agreements*.

Key factors in the industry:

- Bidding for **licences** (i.e. 3G, 4G, LTE) and **privatisation tenders** across emerging markets continues
- European telco companies continue to make **acquisitions in emerging markets**, with the overall **application of corporate governance** to new units still raising concerns

**Bidding for licences** can be marked by opaque procedures. The Indian government has maintained that bids for its 2G licensing process were under priced in 2008 due to a variety of irregularities including the possibility of corruption involving bribes paid to officials. It estimates its losses at USD39.16bn and the fallout has been ongoing and affected a variety of European companies. Indian authorities revoked 122 3G licences from a number of companies after concluding that the entire licence sale had been invalid.

### Vodafone

#### Raids at Vodafone...

According to multiple press reports including the FT and Bloomberg, officials entered Vodafone's Indian offices in November 2011 in relation to these ongoing investigations regarding underpayment for 2G licences. The company denies any wrongdoing.<sup>32</sup> (According to other press articles including the FT and BBC the firm had also faced allegations in Ghana through its majority stake purchase of Ghana Telecom in 2008, where allegations were also of underpayment as a result of bribes<sup>33</sup>.)

Vodafone issues a "Material Issue Analysis" on its website: Ethical Business Practices are held as being at the high end of the medium category for "Influence on Business Success" within its sustainability priorities ("low carbon solutions" are ranked highest). We welcome the appearance of *Ethical Business Practices* in the prioritisation of its sustainability issues but note that the category is classed as of **medium importance to stakeholders** – well behind tax, for example, on which Vodafone had longstanding issues in India. We note that an area such as Business Ethics is sometimes only catapulted to the status of high stakeholder interest when an emergency response is required to reputational issues (i.e. with Siemens).

## VODAFONE

Risk Mitigation Profile	
Revenue reporting for higher risk regions (GBP)	2011: Italy 12.63%, GBP5,722m – India 8.4%, GBP3,855m – Turkey 3.41%, GBP1,566m – Egypt 2.9%, GBP1,329m – Greece 2.05%, GBP927m – Romania 1.57%, GBP710m
Notable policy elements	Shows a robust and publicly declared set of policies, including specific guidance on the UK Bribery Act Supplier conduct provisions in contracts
Whistle-blowing	Anonymous, global, independent, third-party maintained, open to non-employees
Reporting structure	Executive committee is responsible for anti-bribery reporting
Training	Online and face-to-face training being rolled out in high-risk areas
Facilitation payments	Prohibits facilitation payments or small payments to government officials
Zero tolerance	Zero tolerance statement on internal and external websites
UNGC Signatory	UNGC signatory

### Our view

**Well positioned: The company shows public commitment to addressing forms of bribery and corruption and obtaining best practice status. However, it has not been immune to allegations, as the recent raid in India and allegations regarding Ghana Telecom licensing irregularities show.**

Source: Vodafone, Bloomberg, CA Cheuvreux

### ...and writedowns at Telenor

## Telenor

Telenor held 22 Indian licences via its JV with Uninor. It announced writedowns for Q4-11 of SEK4.2bn on licences and goodwill after the Indian government cancelled licences.<sup>34</sup> We note, however, that Telenor has inherited the licensing complications as a legacy impact rather than having been directly involved in the bidding process.

Telenor itself had been accused of paying bribes in Russia to influence the outcome of an acrimonious holdings dispute with Altimo, a Russian telco investment group. However, we remain cautious on this accusation given the circumstances between the two companies, and we reiterate that no actual allegation has been made or pursued by any official authority. Telenor is 54%-owned by the Norwegian State.

## TELENOR ASA

Risk Mitigation Profile	
Revenue reporting for higher risk regions (NOK)	FY 2011 revenues: Thailand 15.39% NOK14,585m Malaysia 11.53% NOK10,929m Bangladesh 7.1% NOK6,730m India 3.19% NOK3,019m Serbia 3.07% NOK2,911m Montenegro 0.66% NOK627m
Notable policy elements	Policies including risk assessment and application to intermediaries Supplier conduct provisions in contracts
Whistle-blowing	"Confidential" reporting to <i>internal</i> management and compliance officer, non-retaliation policy
Reporting structure	Group compliance officer reports functionally to group CEO/audit committee and administratively to group general counsel
Training	No detailed information available
Facilitation payments	Prohibits facilitation payments or small payments to government officials
Zero tolerance	Zero tolerance
UNGC Signatory	UNGC signatory

### Our view

**Telenor's policies show weaknesses in areas of whistle-blowing, and we believe this is of importance as the geographical exposure to emerging markets is sizeable. However, we note Supplier Conduct Principles clearly lay out anti-corruption expectations.**

Source: Telenor, Bloomberg, CA Cheuvreux

## TeliaSonera: Holdings and corporate governance

With geographical diversification common in the telco industry, a key factor in mitigating corruption risk is an acquiring company's ability to influence the firms it holds a stake in. TeliaSonera serves as an illustrative example of the complexities involved in terms of governance influence:

The company's Eurasian revenue for FY-11 represented 17.88% (FY 2010 16.52%) of the total, with Kazakhstan accounting for 8.16% (FY 2010 7.51%). TeliaSonera announced a major acquisition on 22 December 2011 of a 49% stake in Kazakh company KCell for USD1.52bn; it is planning to sell 25% through an IPO in 2012.

TeliaSonera also owns a 38% holding in Turkcell – at which corruption allegations were raised in April 2011 in Kazakhstan<sup>35</sup>. TeliaSonera may be said to have limited control of Turkcell's corporate governance, particularly the independence of the board, and there has been ongoing litigation by TeliaSonera against the chairman of Turkcell for abusing minority shareholder rights.

### TELIASONERA

Risk Mitigation Profile	
Revenue reporting for higher risk regions (EUR)	FY 2011; <i>Eurasia</i> 17.88%, EUR17,388m of which: Kazakhstan 8.16% EUR7,913m Azerbaijan 3.56% EUR3,449m Nepal 2.02% EUR1,960m Uzbekistan 1.79% EUR1,738m Georgia 0.96% EUR926m Tajikistan 0.86% EUR834m Moldova 0.53% EUR518m
Notable policy elements	Risk assessment (by country)
Whistle-blowing	Anonymous "where legally permissible" with non-retaliation policy but internal, managed by Group General Counsel
Reporting structure	Board has overall responsibility for Code of Ethics but reporting structures not declared
Training	New code of ethics in 2010 implementation plans included workshops, specialised roll-out for financial officers
Facilitation payments	Prohibits facilitation payments or small payments to government officials
Zero tolerance	Code of conduct "prohibits the giving or receiving of any form of bribe"
UNGC Signatory	TeliaSonera not direct signatory to UNGC, but as of Feb 2012 the following five legal entities are direct signatories to the UNGC, namely TEO and Omnitel in Lithuania; Kcell in Kazakhstan; Geocell in Georgia and Moldcell in Moldova. Associated company, Turkcell also signed the UN Global Compact

**Our view:** Although TeliaSonera has some sound policies internally there are indications from its experiences (i.e. with TurkCell) that it is still in the process of effectively influencing associated companies.

Source: TeliaSonera, Bloomberg, CA Cheuvreux

**How much influence does the holder have?**

However, the key issue is with associated companies: TeliaSonera's website states: "In associated companies TeliaSonera relies largely on these companies' individual risk and control structures. This is the case with Russian MegaFon and Turkish Turkcell. In these companies, TeliaSonera strives to use Board presence and active ownership practices to promote the implementation of stringent standards and governance."

**And what about their governance?**

While Teliasonera effectively controls the operations and management of KCell, we believe that its ability to continue to implement and monitor governance and ethical standards will be a risk factor. The aim to influence the operating practices – such as anti-corruption – encounters clear difficulty in associated companies at which governance is poor and stakeholders are unable to gain the influence they require to implement suitable changes.

In 2010, TeliaSonera made upgrades to its anti-corruption procedures including an improved whistle-blowing function that it has started to introduce via its intranet, customised to local legislation, and also a complete roll-out of the ethics code to all employees at Eurasian operations.

## Bribes can be used to maintain collusion

## Bribes to aid anti-competitive agreements: Deutsche Telekom and Magyar Telecom Plc

**At the end of December 2011**, US authorities reached a settlement with Hungarian Magyar Telecom and its majority shareholder, Deutsche Telekom AG, to resolve FCPA criminal and civil allegations.<sup>36</sup>

**Penalties:** Magyar will pay USD31.2m to the SEC and USD59.6m to the US Department of Justice (which filed criminal charges against Magyar), with an additional USD4.36m paid by Deutsche Telekom and a two-year deferred prosecution agreement.

The SEC pursued three former Magyar executives, seeking disgorgement and civil penalties. They were said to have fabricated fake consulting and marketing contracts to pay USD6m to Macedonian officials and USD9m to Montenegro officials in attempting to prevent a new competitor from entering the market and to gain regulatory advantages.

### DEUTSCHE TELEKOM

Risk Mitigation Profile	
Revenue reporting for higher risk regions (EUR)	FY 2011: Greece 8.24% EUR3,546m Hungary 3.34% EUR1,438m Romania 2.49% EUR1,1072m Czech Republic 2.54% EUR1,092m Croatia 2.52% EUR1,084m
Notable policy elements	Requires suppliers "as far as possible" to adhere to code of conduct
Whistle-blowing	Whistle-blower portal, anonymity possible, open to third parties
Reporting structure	Compliance department reports to Board
Training	Training provided, no further detail on anti-bribery training
Facilitation payments	No information found through publicly available sources
Zero tolerance	Addresses both Active and Passive Corruption, public and private. "We refrain from engaging in any and all forms of corruption..."...Zero tolerance policy available in Code of Conduct
UNGC Signatory	UNGC signatory

#### Our view

**Policies show some strengths such as in whistle-blowing, but could be strengthened in other areas, overall application to subsidiaries has been the source of concern.**

Source: Deutsche Telekom, Bloomberg, CA Cheuvreux

## France Telecom

**France Telecom** was hit in 2011 with allegations that its Tunisian Orange subsidiary made payments that were diverted from the government directly to a company owned by former President Ben Ali's daughter and her husband. Orange owned 49% of the joint venture and gained 3G licences in 2010. No prosecutions have surfaced, and the CEO has maintained that the firm was not involved in any wrongdoing.<sup>37</sup>

### FRANCE TELECOM

Risk Mitigation Profile	
Revenue reporting for higher risk regions (EUR)	FY 2011: Poland 6.33%, EUR3,625m Egypt 2.15% EUR1,233m Senegal 1.91% EUR1,093m Romania 1.64% EUR937m Slovakia 1.29% EUR737m Jordan 1.18% EUR678m Ivory Coast 0.8% EUR456m
Notable policy elements	Policy extends to suppliers, monitoring and enforcement to be implemented
Whistle-blowing	Mechanism in place, open to third parties
Reporting structure	Ethics compliance committee reports to group chairman and compensation, selection and governance board sub committee annually
Training	2010 anti-corruption compliance programme, board level training
Facilitation payments	No information found through publicly available sources
Zero tolerance	Zero tolerance policy available on external website
UNGC Signatory	UNGC signatory

#### Our view

**Policies show overall strengths in positioning itself to manage the potential residual risks of its geographic revenue and holdings.**

Source: France Telecom, Bloomberg, CA Cheuvreux

## Other telco operators

### TELEFONICA

Risk Mitigation Profile	
Revenue reporting for higher risk regions (EUR)	FY 2011: Latin America 46.53% EUR29,237m, of which Brazil 22.8% EUR14,326m Argentina 5.05% EUR3,174m Venezuela 4.28% EUR2,688m Chile 3.68% EUR2,310m Peru 3.23% EUR2,030m Colombia 2.48% EUR1,561m Mexico 2.48% EUR1,557m Czech Republic 3.39% EUR2,130m
Supplier policy	Risk of corruption assessed in purchasing process
Notable policy elements	Several organisational units cover specific anti-corruption responsibilities
Whistle-blowing	"Business Principles Channel"/ "The Confidential Channel" & website open to third parties allows anonymity and received a total of 121 communications in 2010 5 ( vs. 13 in 2009) incidents of corruption investigated by Business Principles Office 7 (vs. 8 in 2009) dismissals for failure to comply with General Business Principles
Reporting structure	"Audit & Control Commission" and "HR, Corporate Responsibility & Reputation Commission" report to the board
Training	Generic Business Principles online training obligatory for all staff 60,000 staff completed e-learning. Workshops also held
Facilitation payments	No information found through publicly available sources
Zero tolerance	See Business Principles "We will never seek, offer or accept gifts, hospitality, bribes or other inducements to reward or encourage a decision."
UNGC Signatory	UNGC signatory

#### Our view

**Strengths in a variety of anti-corruption mechanisms and a lack of recent reported cases.**

Source: Telefonica, Bloomberg, CA Cheuvreux

### KPN

Risk Mitigation Profile	
Revenue reporting for higher risk regions (EUR)	Minimal exposure outside western Europe: FY 2011 "ROW" 2.28% EUR295m
Notable policy elements	Supplier Code of Conduct contains anti-bribery conditions with Supplier Risk Assessments based on self-completed questionnaire. 2012 focus on fraud and corruption across the group following the UK Bribery Act. 340 reports of corruption in 2011
Whistle-blowing	Anonymous internal hotline
Reporting structure	Group compliance officer periodically reports to management board and audit committee of supervisory board
Training	General e-learning in place, 74% of Dutch employees have "taken note" of company code by year-end 2011
Facilitation payments	No information found through publicly available sources
Zero tolerance	Stated in company code
UNGC Signatory	UNGC signatory

#### Our view:

**Well positioned: Some strengths in policy, but the company could consider making whistle-blowing external. No visible current cases and minimal exposure outside western Europe.**

Source: KPN, Bloomberg, CA Cheuvreux

## TELECOM ITALIA

Risk Mitigation Profile	
Revenue reporting for higher risk regions (EUR)	FY 2011: Italy Wireless 24.94% 7473m, Italy Wireline 45.2% EUR13,542m, Eliminations -5.41% -EUR1,620m Brazil Wireless 24.51% EUR7,343m Argentina 10.75% EUR3,220m (FY 2010: 26.7% outside Italy reported)
Whistle-blowing	Not anonymous, non-retaliation policy
Reporting structure	Committee of internal control and corporate governance are able to make recommendation to board
Training	No information found through publicly available sources
Facilitation payments	No information found through publicly available sources
Zero tolerance	No information found through publicly available sources
UNGC Signatory	UNGC signatory

### Our view

**Bribery and corruption do not specifically show on the company's Sustainability Materiality Matrix. We note also that publicly-declared anti-corruption systems contain notable gaps and potential weaknesses such as in the area of whistle-blowing.**

Source: Telecom Italia, Bloomberg, CA Cheuvreux

## ■ Telecoms equipment

### Alcatel-Lucent

In December 2010, Alcatel-Lucent agreed to pay USD137m to US authorities in order to finalise bribery settlements. The group was suspected of illicit payments in 2000 and the following years in Costa Rica, Honduras, Taiwan and Malaysia in order to win contracts. USD45m is due to the SEC and USD92 to the US Department of Justice. If the group fully complies with the terms of the Deferred Prosecution Agreement (DPA), the Department of Justice will dismiss the charges by 2013.<sup>38</sup>

Three subsidiaries – Alcatel-Lucent Trade International AG, Alcatel Centroamerica and Alcatel-Lucent France – were involved, and the settlement includes a French compliance monitor for a three-year period.

In Malaysia, Alcatel-Lucent was debarred for one year to early 2012.

In Costa Rica, Alcatel-Lucent France paid USD10m in damages to the Costa Rican State for its part in USD2.5m in payments related to presidential election funding in 1998-2002, and a local competitor "ICE" filed USD400m suit in the US for compensation for its loss from Alcatel-Lucent's corruption in May 2011. Pending a legal settlement, Alcatel-Lucent could be banned from tendering in public markets in Costa Rica for a certain period. Alcatel-Lucent generated revenues of EUR3m in Costa Rica in 2010 and expects to generate ca. EUR1.5m in 2011. Therefore, while the loss of the Costa Rican market could significantly damage Alcatel-Lucent's reputation in Latin America, it does not pose a direct financial threat.

Among other measures implemented further to this scandal, the group phased out the use of agents and consultants, laying off about 350 commercial consultants suspected of corruption in 2009, and in 2010 implemented its anti-corruption compliance programme, focused on ensuring employee awareness of and compliance with applicable anti-corruption laws and company policies consistent with the group's zero-tolerance policy.

We note that a Chief Compliance Officer's position has been established, reporting to the Board of Directors, and an Ethics & Compliance training programme exists at the board level. The group's "Compliance Hotline", implemented in 114 countries, enables whistle-blowing, but we note that no complete information is available on whether it allows anonymity or is audited.

## ALCATEL-LUCENT

Risk Mitigation Profile	
Revenue reporting for higher risk regions (EUR)	FY 2011 Americas excl. US 10.3% EUR1,616m China 8.25% EUR1,295m Asia-Pacific 8.93% EUR1,402m RoW 7.11% EUR1,116m
Notable policy elements	Phase-out of commercial agent use
Whistle-blowing	Externally maintained compliance hotline in 114 countries, non-retaliation policy but no information on anonymity or if audited
Reporting structure	Group Chief Compliance Officer position established 2009, reporting to the Board of Directors
Training	2010 anti-corruption compliance programme, board-level training, 84% of the group's employees completed Ethics & Compliance Overview Training Program
Facilitation payments	No information found through publicly available sources
Zero tolerance	Zero tolerance policy available on external website
UNGC Signatory	UNGC signatory

### Our view

**Reform has taken place since the major FCPA settlement leaving Alcatel-Lucent better positioned. Policies and disclosure could be improved in areas of whistle-blowing and facilitation payments.**

Source: Alcatel-Lucent, Bloomberg, CA Cheuvreux

## VI – Oil & Gas

### RISK PROFILE FOR OIL & GAS

Oil & Gas	
Risk level	Very high
Key factors	Facilitation payments, JVs and consortiums, exposure to new revenue transparency laws
Well positioned	Statoil

Source: CA Cheuvreux

- Key future regulation for the sector: Dodd–Frank Act 1504 and EU regulation on country revenue declaration.
- Risk characteristics: Consortiums and joint ventures, use of facilitation payments, and bribes related to transportation & logistics.

#### Background:

Oil and gas operations are characterised by high-value contracts, operations in emerging territories with a significant set of political networks and powerful lobbies.

There is a dependence on governments both for high-level approval and also for day-to-day operations, and there exists some risk of sanction violations from major activities in countries such as Syria, Libya, Iran, Iraq and Burma.

In terms of revenue exposure, the oil and gas sector has the highest revenue streams from those countries considered higher-risk as based on the TI Corruption Perceptions Index.

Furthermore, we see likely changes ahead for the extractives sector in the area of country revenue disclosure. In the US, the Dodd-Frank Act will contain specific provisions mandating SEC-listed oil, gas and mining firms to report payments to governments. Country-level reporting is widely considered poor at the current time, so the proposed transparency requirements, if implemented, aim to result in a considerable increase of detail in reporting at the country and project levels.

A major issue in the oil and gas industry is the **opaque criteria for awarding bids**, particularly in emerging markets – there is often a lack of transparency in the bidding process. As a result, the risk of bribery is automatically elevated.

We also see risk magnified when foreign listed companies work with **local companies without clearly-stated ownership structures** – here the risk is that the beneficial owners have close links to or are directly involved in government.

**Consortiums and JVs can also pose a risk: Three of the five largest-ever bribery prosecutions relate to the oil industry** as a result of the TSKJ Consortium in Nigeria – where the total penalties levied by US authorities totalled over USD1.25bn. Partners, agents and third parties may require improved due diligence within consortiums with clear anti-corruption guidelines and checks.

The sanction regulations against Iraq under the **UN Oil for Food** programme in 2005 led to allegations against a number of oil companies, as well as a large number of non-extractive companies – demonstrating how countries with significant oil wealth, particularly when combined with political regimes where there is a less effective rule of law, increase the corruption risks of companies operating there.

## ■ Super majors

### RDSHELL

#### RDSHELL

Risk Mitigation Profile	
Revenue reporting for higher risk regions (USD)	FY 2011: Asia, Oceania, Africa 31.53% USD148,260m Other Americas 9.03% USD42,467m
Whistle-blowing	Anonymous, externally maintained, non-retaliation, reporting on cases: 2009: 165 violations reported, 126 staff contractor-relationships ended
Reporting structure	Group chief compliance officer established 2009, reporting to the board of directors
Training	Mandatory risk-based compliance training
Facilitation payments	Not permitted
Zero tolerance	Zero tolerance policy available on external website
UNGC Signatory	UNGC signatory, EITI Member

#### Our view:

**Visible doubts aired against some aspects of Dodd-Frank revenue transparency initiatives<sup>39</sup>, but no less exposed than the other European super majors BP and Total SA. Panalpina case settled in 2010.<sup>40</sup> We believe better disclosure could benefit a company of this size and complexity.**

Source: RDSHELL, Bloomberg, CA Cheuvreux

### BP

Allegations that a BP employee may have taken cash bribes in order to give preferential terms to a supplier in the tanker division have been reported in UK paper *The Daily Telegraph*<sup>41</sup>. The facts of the case still remain unclear. However, we note specific prohibitions in the BP Code of Conduct regarding the receipt of cash from third parties for employees and clear guidance prohibiting the nature of allegations reported.

#### BP

Risk Mitigation Profile	
Revenue reporting for higher risk regions (USD)	FY 2011: non-US sales: 64.98% USD244,029m
Notable policy elements Strength	Guidance for joint ventures mentioned, specific preparation for UK Bribery Act
Whistle-blowing	Externally maintained, non-retaliation policy, anonymity. Cases reported: 552 dismissals for violations of code of conduct and 14 contracts terminated (2010)
Reporting structure	Safety, ethics and environment assurance committee board committee
Training	Over 2,250 key employees trained by specialist team. 7,400 completed online training
Facilitation payments	Not permitted
Zero tolerance	Zero tolerance policy available on external website
UNGC Signatory	UNGC signatory, EITI Member, "Corporate Supporter" of Transparency International

#### Our view:

**Though BP has not been immune from allegations<sup>42</sup>, we note some strong anti-bribery policies in several key areas.**

Source: BP, Bloomberg, CA Cheuvreux

## Total SA

### TOTAL SA

Risk Mitigation Profile	
Revenue reporting for higher risk regions (EUR)	FY 2010: 23% overall; Far East and RoW, 15.58% EUR24,820m Africa 7.89% EUR12,561m Website states "About 25% of Total's employees work in countries deemed to be high risk according to the TI Corruption Perception Index" <sup>43</sup>
Whistle-blowing	Externally maintained, non-retaliation policy, anonymity can be requested, complaints transmitted to Head of Group Audit Department
Reporting structure	Ethics committee responsible for proper application of Code of Conduct.
Training	Ethics intranet site, dedicated programmes on "Ethics & Business" are compulsory for new senior executives, 2,500 managers receive ethics training
Facilitation payments	These "should be actively discouraged in all cases". Integrity Guide notes that they are not illegal under FCPA, "You should always seek legal advice before making any such payments."
Zero tolerance	Zero tolerance policy available on the external website "Total SA rejects bribery and corruption in all forms, whether public or private, active or passive"
UNGC Signatory	UNGC signatory, EITI Member

#### Our view:

**Court case underway in France over its UN Oil-for-Food programme activity despite the company maintaining it has not entered into any wrongdoing. New Anti-Corruption Compliance Directive issued in 2011. Website states "more than 60% of ethics processes are operating satisfactorily, 25 to 30% could use improvement and 10 to 15% are in need of strengthening" according to ethical assessments.**

Source: Total SA, Bloomberg, CA Cheuvreux

Total SA is currently facing continued bribery allegations involving its Oil for Food Programme activity in Iraq. **The case is a critical one as it involves the current CEO Christophe de Margerie himself.**<sup>44</sup> This investigation is still underway in France and the trial is reportedly to take place in 2012. Total SA has released an official statement declaring it is confident "about the investigation's outcome and that Total will be cleared of these allegations"<sup>45</sup>

## ■ Other oil companies

### Statoil

In 2004, Statoil was found guilty in the Norwegian courts of paying bribes in Iran. It was fined NOK20m and the former chairman, CEO and director of international operations resigned.<sup>46</sup> The US fines amounted to USD21m. Although in Norway, Statoil initially denied guilt even though it paid the fines, the later SEC settlement in 2006 included a clause that Statoil could not give media interviews contradicting their admissions that they paid specific bribes in Iran to secure contracts and used false accounting.

In 2009, Statoil satisfied the obligations of the Deferred Prosecution Agreement and therefore the charges were dismissed;

*"Three years of diligent efforts by Statoil to address past misconduct and serious compliance failures have led to the dismissal of foreign bribery charges against the company,"* (US Assistant Attorney General Lanny A. Breuer).

## STATOIL

Risk Mitigation Profile	
Revenue reporting for higher risk regions (NOK)	FY 2011: RoW 6.75% NOK45,141m
Notable policy elements	"Integrity Due Diligence" processes. Code of ethics applies to "consultants and lobbyists" with business partners "expected" to adhere
Whistle-blowing	Externally maintained, non-retaliation policy, anonymity
Reporting structure	HSE and ethics committees report to the Board
Training	93% of employees completed anti-corruption training by end 2009. 1,100 employees and consultants trained in 2010. 595 attendees of whole day corruption workshops in 2010
Facilitation payments	Not permitted; "Statoil is against the use of this type of payment even in cases where it may be legal, and will work actively to prevent such payments"
Zero tolerance	Zero tolerance policy available on external website
UNGC Signatory	UNGC signatory, EITI Member

### Our view

**Well positioned: Following the dismissal of the FCPA charges, Statoil has conducted a systematic cleanup with official external recognition.**

Source: Statoil, Bloomberg, CA Cheuvreux

## ENI

ENI reached a settlement with the US authorities for a total of USD365m but is currently allegedly<sup>47</sup> under investigation for the receipt of bribes via offshore accounts for contracts in Iraq and Kuwait from other services firms, according to Reuters. Two of the firms in question, Ansaldo Energia and Ansaldo STS, are controlled by aerospace & defence firm Finmeccanica. This is in conjunction with oil services firm Saipem (43%-owned by ENI).

## ENI

Risk Mitigation Profile	
Revenue reporting for higher risk regions (EUR)	FY 2010: Italy 48.52% EUR47,802m Africa 13.26% EUR13,068m Americas 6.38% EUR6,282m Asia 5.87% EUR5,785m
Whistle-blowing	Externally maintained, anonymous, non-retaliation policy, open to third parties. Reporting shows 39% of reports related to code of ethics
Reporting structure	Anti-corruption legal support unit reports to legal affairs. Internal audit deals with cases reporting to the board
Training	Anti-Corruption training "currently being developed"
Facilitation payments	Prohibited
Zero tolerance	"Ethical Code" forbids corrupt practices
UNGC Signatory	UNGC signatory, EITI Member

### Our view

**Strong policies that were upgraded in some areas in January 2012. Particular care needs to be applied to holdings and subsidiaries and we believe that the new policies introduced this year show well thought-out objectives in this area, which will require suitable enforcement.**

Source: ENI, Bloomberg, CA Cheuvreux

## Repsol YPF

### REPSOL YPF

Risk Mitigation Profile	
Revenue reporting for higher risk regions (EUR)	FY 2011 - Rest of World 17.03% EUR10,472m Argentina 15.66% EUR9,634m OECD countries 11% EUR6,766m
Notable policy elements	Criteria to combat bribery to be included in audits of non-operated assets
Whistle-blowing	Open to third parties, reports received by the ethics committee, non retaliation policy, "in complete confidence". 131 communications in 2010. 25 dismissals in 2010 related to failure to comply with Ethics & Conduct regulation, down from 38 in 2009
Reporting structure	Ethics committee responsible for bribery area
Training	2010 training programme aimed at 5,000 employees in the service station network, also an Ethics & Human Rights session at the annual conference attended by 650 employees including those from Purchasing and Contracts. 16% of employees reached in 2010
Facilitation payments	Ethics and Conduct Regulation: "Repsol YPF employees may not make payments to facilitate or expedite formalities"
Zero tolerance	"Repsol YPF may not directly or indirectly make or offer any payment in cash, in kind or whatsoever other benefit..."
UNGC Signatory	UNGC signatory

**Our view:**

**A variety of anti-bribery measures have been introduced with some statements regarding enforcement and ongoing work in the area including audits on non-operated assets.**

Source: Repsol YPF, Bloomberg, CA Cheuvreux

## Neste Oil

### NESTE OIL

Risk Mitigation Profile	
Revenue reporting for higher risk regions (EUR)	FY 2011 Baltic Rim 9.24% EUR1,425m
Notable policy elements	New code of conduct in 2010
Whistle-blowing	Online only, anonymous, internal
Reporting structure	Misconduct reported to Board audit committee
Training	Code of conduct training in 2011
Facilitation payments	No information found through publicly available sources
Zero tolerance	"Code of conduct forbids bribery or corruption"
UNGC Signatory	No

**Our view:**

**A mid-cap with some basic anti-corruption constituents in the new 2010 code of conduct. No incidents reported.**

Source: Company Filings, Bloomberg, CA Cheuvreux

## Oil & Gas Services

### Technip

The firm faced allegations of bribery in Nigeria as part of the TSKJ consortium - related to an LNG project at Bonny Island between 1994 and 2004. Technip reached a settlement in June 2010 to pay USD240m over a two-year period to the US Department of Justice, and USD98m to the SEC (as disgorgement), and in December 2010 it entered into agreement with the Nigerian authorities to pay fines and costs of USD32.5m. The settlement included vastly improved compliance policies and monitoring.<sup>48</sup>

Technip has an Ethics & Governance Committee consisting of board members and an Ethics & Compliance Committee made up of senior managers reporting to the chairman and CEO.

### TSKJ Consortium risk

#### TSKJ CONSORTIUM: MAJOR JV COMPANIES CHARGED

JV Partner	Compliance monitor appointed	Total penalties larger than benefits received	Value of benefit received from improper payments according to DoJ (USD m)	Penalty (USD m)
KBR & Halliburton	3 years	Yes up to ratio of 1.7	235.5	402 177 disgorgement
Technip	2 years	Yes up to ratio of 1.2	199	240 98 disgorgement
Samprogetti, ENI	No monitor	Yes up to ratio of 1.2	214.3	240 125 disgorgement
JGC Corp	Monitor appointed	Yes up to ratio of 1.1	195.4	218.8 in penalties

Source: Department of Justice, Newswires

#### TECHNIP

Risk Mitigation Profile	
Revenue reporting for higher risk regions (EUR)	FY-11 Middle East 22.16% EUR1,509m Asia-Pacific 13.68% EUR931.8m Europe Russia & Central Asia 25.68% EUR1,749.4m
Whistle-blowing	Anonymous procedure introduced in June 2010, complaints sent directly to the "Ethics & Compliance Committee", non retaliation policy
Reporting structure	Ethics & Governance Committee consisting of board members, Ethics & Compliance Committee made up of senior managers reporting to the chairman & CEO
Training	Legal compliance training for all personnel, ethics training carried out for managers, ethics awareness and 2011 poster campaign, with online training also available.
Facilitation payments	"Ethics in Business" document advises "Don't offer facilitation payments...for any reasons (direct or indirect...) or use third parties to offer or accept ...facilitation payments..."
Zero tolerance	"Ethics in Business" states "All acts of Corruption are strictly prohibited"
UNGC Signatory	UNGC signatory

#### Our view:

Policies introduced that relate to third-party due diligence, an anonymous whistle-blowing policy and guidelines on gifts and hospitality are a step forward following the USD338m settlement in June 2010<sup>49</sup>. However, the claim in the annual report for the same fiscal year that the UK Bribery Act "will have little impact on Technip as its standards are already among the highest currently in force" sounds over confident.

Source: Technip, Bloomberg, CA Cheuvreux

## Tenaris

### TENARIS

Risk Mitigation Profile	
Revenue reporting for higher risk regions (USD)	FY 2010: South America 24.79% USD1,912m Middle East and Africa 16.4% USD1,265m Far East & Oceania 5.63% USD434m
Whistle-blowing	Compliance hotline, anonymity possible, non retaliation policy, open to non-employees, operates under supervision of audit committee
Reporting structure	Audit committee responsible for implementation of Code of Conduct
Training	Business ethics included in new hire orientation
Facilitation payments	Required to implement policies governing facilitation payments according to DoJ document <sup>50</sup>
Zero tolerance	"Tenaris will not condone, under any circumstances, the offering or receiving of bribes" the Policy on Business Conduct extends this to use of intermediaries, agents, subsidiaries and JVs
UNGC Signatory	No

#### Our view:

**Strong zero-tolerance statement and Code of Conduct applies to agents, suppliers and consultants. May 2011 Deferred Prosecution Agreement reached with SEC in the US included a USD5.4m payment for disgorgement and prejudgment interest. A further USD3.5m criminal penalty to DoJ<sup>51</sup>. Official allegations stated almost USD5m in profits were made through bribes to government officials in Uzbekistan.**

**However, the statement by SEC Enforcement Division's FCPA Unit Chief concluded "...when Tenaris discovered the illegal conduct, it took noteworthy steps to address the violations and significantly enhance its anti-corruption policies and practices to remediate weaknesses in its internal controls".<sup>52</sup>**

Source: Tenaris, Bloomberg, CA Cheuvreux

## Saipem

### SAIPEM

Risk Mitigation Profile	
Revenue reporting for higher risk regions (EUR)	FY 2011: West Africa 21.38% EUR2,692m North Africa 20.1% EUR2,531m Asia 16.26% EUR2,047m CIS 13.57% EUR1,709m Americas 5.3% EUR667m Italy 4.31% EUR543m
Whistle-blowing	Anonymous with quarterly reporting to external auditors, non retaliation policy
Reporting structure	Compliance Committee and Legal Affairs Anti-corruption unit feeds back to board
Training	600+ managers trained in 2010. Mandatory anti-corruption training for key personnel
Facilitation payments	Guidance on payments to public officials but specific policy on facilitation payments not declared
Zero tolerance	Code of Ethics: "Bribes, illegitimate favours, requests...are prohibited without exception"
UNGC Signatory	No

#### Our view:

**The Snamprogetti Netherlands B.V. subsidiary (a former subsidiary of ENI) entered into a deferred prosecution agreement in 2010 in the US<sup>53</sup>. No independent monitor required.<sup>54</sup>. Trial still underway in Italy, but no material impact according to company press release due to ENI agreeing to indemnify Saipem when it was sold (ENI holds 42.93% of Saipem). Over 70% of revenue from Asia, Africa and CIS. However, we note detailed and comprehensive policies have been recently introduced including the requirement of all intermediaries, partners and "covered business partners" (who have contact with public officials), which could mitigate some corruption risk if well enforced.**

Source: Saipem, Bloomberg, CA Cheuvreux

### ***In it together: a transportation company and its client***

All sectors are dependant on logistics and transport, but the oil and gas sector carries additional requirements in terms of licensing, customers and documentation within a highly-regulated international environment. **Transportation companies** are presented with a particular dilemma – is a bribe paid by the transporter ultimately for its own benefit or the owner of the goods transported? The case against Panalpina implicated both itself and its clients, including RDSHELL, with overall penalties against all the guilty parties amounting to USD236.5m.

**Shell Nigerian Exploration** received a criminal fine of USD30m to settle charges stemming from its use of Panalpina as an agent in Nigeria. Royal Dutch Shell Plc the parent company paid USD18m in disgorgement and interest.

The charges are that the firm paid bribes to customs officials in 12 countries to obtain undue advantages regarding customs charges, import processes and taxes. It is alleged that false documentation was expressly requested by local RDSHELL employees and that Panalpina complied. **Panalpina itself paid USD81.5m in fines.**<sup>55</sup>

### **PANALPINA**

Risk Mitigation Profile	
Revenue reporting for higher risk regions (CHF)	FY 2011: Europe, Africa, Middle East, CIS Block 48.78% CHF3,171m Central and South America 12.83% CHF834m Asia-Pac. 18.85% CHF1,225m
Notable policy elements	Third-party due diligence. Third-party guidance, gifts hospitality entertainment and expenses and political contributions policies
Whistle-blowing	Externally maintained compliance hotline in 114 countries, non-retaliation policy but no info. on anonymity or if audited
Reporting structure	Corporate Compliance Officer reports directly to CEO and Legal and Compliance Board Committee
Training	Face-to-face and web based
Facilitation payments	Prohibited
Zero tolerance	Zero tolerance commitment from CEO
UNGC Signatory	UNGC signatory, PACI

#### **Our view:**

**Well positioned: Continued expansion in China and the Asia-Pacific region, but overall policy strengths and reform since major corruption prosecution may go some way to mitigating risk. However, we lack visibility on application and enforcement of policies.**

Source: Panalpina, Bloomberg, CA Cheuvreux

## **■ Revenue transparency regulation in the extractives sector**

**The Dodd-Frank 1504** provision, which is currently under review in the US, aims to require companies to disclose their government revenues and payments (**includes those related to transport, processing and exports**) in all countries. However, another revenue transparency initiative - the EITI - requires signatory countries that have voluntarily signed up to disclose the receipt of payments and reconcile them with those declared by companies. These two initiatives, together with EU regulation under discussion, present a potentially significant step in using transparency as a tool to make bribe payments more difficult to conceal. Dodd-Frank legislation is expected to be fully implemented this year, with companies therefore reporting in 2013, but the regulation has previously been delayed and we cannot say with certainty when it will be implemented.

One-third of the world's extractive market cap. is listed on US exchanges. This is particularly relevant given not only that the US is the strongest prosecutor against a sector with extremely high exposure to corruption risks, but also as the country is introducing a raft of legislation to enforce the transparency of extractive companies (Dodd-Frank Amendments 1502 and 1503 cover conflict minerals and mining safety declarations).

**REVENUE TRANSPARENCY REGULATION EXPOSURE: OVER 55% OF EXTRACTIVE COMPANIES LISTED IN US & EU**

Global market value and numbers of listed companies				
Exchange/Exchange Group	Total no. of listed companies	Total no. of extractive companies	Extractive sector market cap. (EUR)	% of world extractive sector market cap.
<b>US Exchanges (3)</b>	<b>5 030</b>	<b>503</b>	<b>2 018 375 209 241</b>	<b>32.67%</b>
<b>Deutsche Börse - Frankfurt</b>	<b>--</b>	<b>2 083</b>	<b>685 504 376 580</b>	<b>11.10%</b>
TSX Toronto (TMX Group)	3 894	543	622 869 565 957	10.08%
<b>London SE Group (London and Italy)</b>	<b>2 918</b>	<b>363</b>	<b>572 793 828 258</b>	<b>9.27%</b>
Australian SE	2 019	1 041	306 247 953 498	4.96%
Shanghai SE	921	86	298 392 538 544	4.83%
Johannesburg SE	400	75	264 348 302 430	6.35%
National Stock Exchange India	1 615	153	259 610 594 442	4.20%
BM&FBOVESPA Brazil	377	91	205 798 329 760	3.33%
<b>NYSE Euronext (Amsterdam, Brussels, Lisbon, Paris)</b>	<b>1 133</b>	<b>88</b>	<b>168 325 990 704</b>	<b>2.72%</b>
Sum of non-US extractive sector market capitalisation			4 159 748 790 021	
Total extractive sector market capitalisation			6 178 123 999 262	

Source: TI, EITI

**Proposed EU regulation** follows the US lead but goes further to cover large privately-held companies defined as having two of the following criteria: annual sales >EUR40m, EUR20m in assets, and 250 employees. It also includes "sub-national governments" and the forestry industry.

As there are an increasing number of emerging market companies in this sector with European and US listings, regulation in the US and the EU will either push these companies to improve disclosure particularly before listing or it may have the effect in very extreme circumstances of certain companies delisting from US exchanges.

The disclosure will cover production licences, taxes, royalties and other aspects of energy and mineral projects, however, it remains to be seen how the definition of "projects" may be used by companies when implementing the law.

Considerable discord remains over the implementation of Dodd-Frank 1504. RDSHELL for example has written to the SEC requesting disclosure: a) be limited to material projects only; and b) allow exemptions to disclosure if the host country's laws forbid it. It cites the examples of China and Qatar, both of which are of crucial strategic importance to a large number of companies in the sector<sup>56</sup>. NGOs such as RevenueWatch counter these arguments to maintain the countries' laws would not be broken. Some companies have also called for more clarity over the definition of "project by project" reporting.

### REVENUE WATCH & TI SURVEY: COUNTRY-LEVEL DISCLOSURE SCORES

Company	Country-level disclosure score
Statoil	69%
Repsol YPF	25%
ENI	20%
OMV	15%
BP	14%
Total SA	11%
RDSHELL	10%
BG Group	8%

Source: "Promoting Revenue Transparency" Report on Oil & Gas Companies Revenue Watch, Transparency International 2011

The above table transcribes survey results by NGOs Revenue Watch and Transparency International, which measured country-level reporting by oil and gas companies. The average score for the 20 global companies measured was low at 16%, with Statoil being clearly ahead (the next best was Nexans at 54%). The change in reporting mechanisms toward greater transparency will therefore unarguably be a major change for the extractives industries.

## VII – Capital Goods

### RISK PROFILE FOR CAPITAL GOODS

Capital Goods	
Risk level	Very high
Key factors	Facilitation payments, JVs, consortiums, we estimate capital goods companies have an average 35% exposure to emerging markets
Well positioned	Siemens

Source: CA Cheuvreux

The capital goods sector has been host to the largest-ever corruption penalty via Siemens.

Capital goods companies have systematic exposure to high-value government contracts and operate in high-risk territories. There is also some risk for systematic use of facilitation payments as exposure to government officials may be high on certain projects. Finally, as they also sub-contract, they can be vulnerable to receiving illicit payments, as they can be dominant within major supply chains.

- The sector is below average in the TI TRAC survey for corruption reporting and systems and classed as high risk (the cap goods sector stands at 15 vs. a sector-wide average of 17).
- According to Bloomberg data covering 136 western European capital goods sector companies (GICS Industry Group), 121 were found to have no whistle-blower policy.

### Siemens

**Siemens holds the record for the largest-ever set of penalties at USD1.8bn in fines and disgorgement. Total costs are estimated at well over EUR2bn in addition to overall UN Contract debarment of six months, with the Russian subsidiary suffering a four-year debarment (and not even allowed to contest this according to the settlement conditions).**

It was also debarred from bidding for World Bank projects up to 31 December 2010. It accepted a commitment from World Bank Group to spend USD100m over 15 years to support global efforts to fight corruption.

#### **Incidents for illustration:**<sup>57</sup>

- Allegations surfaced in Kuwait in June 2011 after employee whistle-blowing over an energy and water ministry project worth EUR1.25m. The positive sign was that the incident was internally detected. Siemens maintained that it was looking at bringing charges against the former managers involved<sup>58</sup>.
- There were allegations by the Greek government of payments made to public officials, politicians and former management of Hellenic Telecommunications between 1997 and 2002 to win contracts for the 2004 Olympic Games after making alleged bribery payments. In March 2012, a settlement was reached with the Greek government, which accepted EUR170m<sup>59</sup>. The deal also included a EUR100m investment by Siemens in its Greek subsidiary and reopened access for Siemens to the country's public procurement system.
- In May 2010, Siemens lost the right to bid for World Bank-funded projects in four African countries (Nigeria, Egypt, Cameroon and Liberia), following accusations of bribing officials to secure telecom supply contracts.

■ In April 2009, in Bangladesh, Siemens was cited as having paid USD180,000 in bribes to win a USD40m contract with the Bangladeshi government.<sup>60</sup>

■ After Siemens was found guilty by a Munich court of charges of bribery in October 2006 in relation to paying bribes in Nigeria, an investigation was launched by local authorities between 2002 and 2005. EUR10m of bribes had been paid to local officials between 2001 and 2004. However, after out of court settlements in the "mid double digit euro million range", the debarment and charges were dropped according to official Siemens legal announcements.<sup>61</sup>

Siemens "remains subject to corruption-related investigations in several jurisdictions around the world" according to its 2011 legal proceedings releases.<sup>62</sup>

A key characteristic of probes against Siemens was that investigators found that the company had established "cash desks" where its employees could receive bank notes that would be used to secure contracts.

In 2006, the company made wide-reaching changes to its management team (board members concerned in the affairs and many other top managers were replaced) and put processes in place to raise awareness of compliance issues amongst the entire workforce in an attempt to change the corporate culture. It implemented a compliance programme with the objective of becoming a "benchmark in transparency and compliance by 2010". A compliance monitor carried out in September 2009 showed improvement. However, the compliance monitor also made some recommendations: one is related to the involvement of middle management, which it says should be intensified. The company has adopted targeted measures to continuously improve the programme.

Siemens also launched an "Integrity Initiative" (with a budget of USD100m) to support organisations and projects to fight corruption. Due to the efforts it has made, the investigations by the World Bank into allegations of corruption were terminated in July 2009.

The company measures the effectiveness of compliance training activities through regular employee surveys and the reporting of suspected compliance violations through a confidential, anonymous system. 565 incidents were reported in 2009 vs. 539 in 2008 and 156 in 2007. In 2009, Siemens increased its management's responsibility by making compliance a component of the bonus system for senior managers: the compliance-related portion rose to 20% (17% in 2008) for each respective organisational unit. 5,500 executives company-wide are concerned.

Siemens also established compliance-related sanctions that can involve warnings or dismissals/separation. In 2009, 784 disciplinary sanctions were pronounced (31% dismissals) vs. 909 in 2008 (26 % dismissals) and 134 in Q3 2010.

With the help of the quarterly disclosures on compliance, we (and the group) will progressively become better equipped to measure Siemens' performance progress. Compliance is represented on the Management Board (Peter Solmssen). In addition, Dr Theo Waigel, former German Minister of Finance, has been contracted as compliance monitor, regularly reporting on the effectiveness of compliance measures.

Therefore, compliance continues to be a high-priority issue within the company. While compliance responsibility rests with management, the compliance review process in the various businesses and regions involves quarterly reports as well as the discussion of important compliance issues in regular management meetings. The assessment of corruption risks has become part of Siemens' IT-based Limits-of-Authority process for approval of customer projects. A web-based tool has been introduced to regularly train staff, with more than 45,000 employees trained within the first 12 months after introduction.

## SIEMENS

Risk Mitigation Profile	
Revenue reporting for higher risk regions (EUR)	FY 2011 - Americas excl. US: 10.3%, EUR1,616m China: 8.25%, EUR1,295m Asia Pac.: 8.93%, EUR1,402m ROW: 7.11%, EUR1,116m
Notable policy elements	Attempt to move to a "value based" code of ethics rather than one purely rules based
Whistle-blowing	Externally maintained compliance hotline in 114 countries, non-retaliation policy but no info on anonymity or if audited
Reporting structure	Group Chief Compliance Officer and Chief Counsel Compliance report to Peter Solmssen, General Counsel (Managing Board). Approx 600 heads within compliance function.
Training	2010 anti-corruption compliance programme, board level training
Facilitation payments	"Siemens prohibits payments for routine action", "Approval will not be given"
Zero tolerance	"...no contraventions will be tolerated", Zero tolerance policy available on external websites
UNGC Signatory	UNGC Signatory

### Our view:

**Well positioned: Siemens has implemented best practices in most areas of anti-corruption. The recent case in Kuwait, where internal whistle-blowing led to the disclosure of bribery, highlights that though cases may still exist, Siemens' systems allow them to be investigated and responded to through enforcement of strong policies. However, fallout from the systemic corruption continues to hit the headlines, and this extends to the recent personal settlements of former executives and board members.**

Source: Company Filings, Bloomberg, CA Cheuvreux

## Royal Philips Electronics NV

According to press reports, including Reuters as a source, Philips' Hamburg offices were recently raided (February 2012) in relation to allegations that officials were bribed to attend conferences.<sup>63</sup>

Furthermore, three employees were fired from Philips in 2011 related to bribes paid in Poland for medical equipment sales between 1999-2006 worth USD955,000. 10% of costs are said to have been allotted to the "signing process".<sup>64</sup> Notably the annual report for the company states it "cannot meaningfully quantify any FCPA fine" illustrating how widely penalties can vary.

## PHILIPS

Risk Mitigation Profile	
Revenue reporting for higher risk regions (EUR)	FY 2011: ROW 41.33%, EUR9,331m China 9.31%, EUR2,102m
Notable policy elements	General business principles mention specifically the OECD Convention, US FCPA, and UK Bribery Act must be complied with internally and "expects the same from business partners"
Whistle-blowing	Ethics hotline, anonymous with non retaliation policy
Reporting structure	Compliance Officers report to Corporate Review Committee which advises the Board of Management
Training	2010 roll-out of a company-wide anti-corruption training programme, FCPA e-learning course completed by 35,000 targeted employees
Facilitation payments	General Business Principles state: "In general, Philips is opposed to the making of facilitating payments. The company will promote measures to eliminate such practices."
Zero tolerance	General Business Principles: "Bribes in any form are unacceptable"
UNGC Signatory	UNGC signatory

### Our view:

**Raids at the Hamburg offices and recent allegations involving the former director of Philips Poland show the company may encounter reputational challenges despite a strong whistle-blowing policy and other areas of anti-corruption policies which have been made more robust.**

Source: Company Filings, Bloomberg, CA Cheuvreux

### ThyssenKrupp and the Ferostaal Joint Venture

A JV called Marine Force International (MFI) between Thyssen and Ferostaal was formed to sell the ThyssenKrupp HDW submarines unit.

German magazine *Der Spiegel* carried a story in October 2011 alleging Thyssen had made payments to the same South Korean contact involved in a Tognum probe.<sup>65</sup>

However, a ThyssenKrupp internal investigation concluded it had made no improper payments. We are unable to confirm if the exit from the JV was due to these allegations.

#### THYSSENKRUPP

Risk Mitigation Profile	
Revenue reporting for higher risk regions (EUR)	FY 2011: Asia 12.96%, EUR5,618m Non-EU Europe: 5.93%, EUR2,573m
Whistle-blowing	Externally maintained by top-tier law firm but not anonymous (name taken and not given "on request" - this can be considered a disincentive). Non retaliation policy and open to third parties
Training	e-learning, 25,000 trained in anti-corruption, in addition to classroom training
Facilitation payments	No information found through publicly available sources
Reporting	Chief Compliance Officer reports to a designated board member
Zero tolerance	Publicly declared zero tolerance policy in Compliance Commitment of Executive Board "Corruption will not be tolerated"
UNGC Signatory	UNGC Signatory

#### Our view:

**Thyssen faced allegations in the German Press ("Der Spiegel")<sup>66</sup> regarding its JV. Some policy areas such as lack of anonymity in the whistle-blower policy and lack of a publicly declared facilitation payments prohibition policy may point to potential weakness.**

Source: Company Filings, Bloomberg, CA Cheuvreux

### Alstom

In November 2011, Alstom Network Schweiz AG agreed to pay CHF36.4m in compensation and a CHF2.5m fine to the Swiss authorities in bribery-related charges concerning payments to government officials in Latvia, Tunisia and Malaysia by its "commercial agents"<sup>67</sup>. The Swiss Attorney General found no evidence to support allegations of any co-ordinated bribery systems within the company such as the "slush funds" which had been used by Siemens (resulting in EUR1bn+ in fines).

Three UK board members were arrested in England in March 2010 (but later released) in relation to alleged payments amounting to GBP81m between 2004 and 2010. Of the three board members, two remain in their positions and the third is deceased.

Significantly, in Norway, at the end of 2011, the influential Norwegian Government Pension Fund Global put Alstom on a four-year observation period regarding potential corruption risks in its businesses. A report issued by the Norwegian Council of Ethics in December 2010 recommended the exclusion of the company from the fund highlighting that *"the management of Alstom does not take the problem (of corruption) seriously enough"* as *"management considers that the company is the victim, and thus transfers the responsibility for the misconduct onto individual employees."*

As a significant part of Alstom's revenues (at least 40%)<sup>68</sup> are derived from countries classed as high risk by NGO "Transparency International", robust anti-corruption systems are critical.

The company has tightened its controls in a number of ways through its "Integrity Programme" including an external audit, adherence to voluntary anti-bribery indicatives, and an Ethics e-learning module made compulsory for managers. Alstom's Code of Conduct already had a specific code of ethics regarding political contributions, charitable contributions and sponsorship, and now also prohibits facilitation payments or small

payments to government officials – which positions it well for the major initiative of the UK Bribery Act introduced in July 2011.

In April 2012, Reuters and multiple other sources reported an EBRD probe in Slovenia related to a coal-fired power plant upgrade. Further funds from the EUR200m EBRD investment will not be released without Slovenian government guarantees but it is not officially halting payments<sup>69</sup>.

## ALSTOM

Risk Mitigation Profile	
Revenue reporting for higher risk regions (EUR)	FY 2011: Asia Pac 18.1% EUR3,788m Middle East/ Africa 16.63% EUR3,480m South & Central America 5.21% EUR1,090m
Notable policy elements	Stricter control of the use of and payments to external third-party "sales consultants" but these measures will need enforcement on an ongoing basis No specific private bribery mention
Whistle-blowing	Alstom maintains an anonymous whistle-blowing system only in some but not all territories
Reporting structure	Board Level Committee Ethics, Compliance and Sustainability and SVP Ethics & Compliance in place with 200 global voluntary "ambassadors" (Country Presidents in charge of governance and managers from Legal, Financial & HR)
Training	Ethics Training Included in induction of new employees. Ethics e-learning module available and made compulsory for managers.
Facilitation payments	"Alstom prohibits any such practices"
Zero tolerance	Code of Ethics "prohibit all unlawful payments and practices"... "Always refuse corruption in business transactions"
UNGC Signatory	UNGC Signatory

### Our view:

**We welcome the group's policy for stricter control of the use of and payments to external third-party "sales consultants", but these measures will need strict enforcement on an ongoing basis. We believe an anonymous whistle-blowing policy is integral to this effort and we note that Alstom currently maintains an anonymous system only in some but not all territories.**

Source: Alstom, Bloomberg, CA Cheuvreux

## ABB

According to several news sources including Bloomberg, ABB reached a settlement with US authorities in September 2010, paying a total of USD58.3m in disgorgement (USD22.8m), prejudgment interest and fines. The charges were related to an electric utility in Mexico and the UN Oil-for Food programme in Iraq.<sup>70</sup>

- The allegations in the Mexican case were that USD2.7m in payments had been made to obtain over USD100m in total according to SEC documents<sup>71</sup>.
- The Iraqi case relates to subsidiaries e alleged to have paid USD300,000 in bribes to the Iraqi government. Revenues generated were USD13.5m and profits USD3.8m.

Although there is no external compliance monitor, ABB had to agree to various provisions as part of the settlement including:

- Continued implementation of a detailed compliance programme as recommended by an independent consultant;
- Creation of a compliance officer position, who will report to the Audit Committee and General Counsel;

- Bi-annual status reports to US authorities. The key risk is the requirement to report "any credible evidence of newly discovered reported violations". Furthermore, reporting of investigations or disciplinary actions stemming from violations; in 2010 ABB reported no dismissals but one investigation.

## ABB

Risk Mitigation Profile	
Revenue reporting for higher risk regions (EUR)	FY 2011: Asia 26.68% EUR10,136m Middle East & Africa; 10.93% EUR4,154m
Whistle-blowing	"Ethics Hotline" third party maintained, allows anonymity. Stakeholder hotline available to external business partners
Reporting structure	Chief Integrity Officer reports to the Board
Training	95% of employees trained in anti-corruption procedures. Face to face and e-learning required for new employees, managers required to "re-acknowledge" Code of Conduct adherence regularly
Facilitation payments	"As a rule facilitation payments are not permitted"
Zero tolerance	"Strict Zero Tolerance policy"
UNGC Signatory	UNGC signatory, PACI

### Our view:

**Strong policies, including wide coverage of training, show the development of an anti-corruption culture, which is a pre requisite following FCPA settlements<sup>72</sup>. Risk review procedures also cover corruption risk and third-party agreements include anti-bribery provisions.**

Source: ABB, Bloomberg, CA Cheuvreux

## Atlas Copco

## ATLAS COPCO

Risk Mitigation Profile	
Revenue reporting for higher risk regions (EUR)	FY 2011 - South America: 9.38% EUR7,595m Africa/ Middle East: 8.71% EUR7,053m Asia/Australia: 28.95% EUR23,437m
Whistle- blowing	Anonymous "Group Ethical Helpline", 2010 reporting states, of 26 possible violations of the Business Code of Practice, "the relation to corruption was difficult to distinguish". Managed internally by the legal department
Reporting structure	Internal Audit & Assurance reports to the board on corruption issues
Training	Code of Practice classroom training includes corruption, with e-learning being developed. 80% received Business Code training internally at the local level. 3,000 employees signed anti-corruption certificates 2010
Facilitation payments	"We do not tolerate bribes and corruption, including facilitation payments. Firm actions will be taken on any violation."
Zero tolerance	Code of Business Practice as above; "We do not tolerate bribes and corruption". "No corruption or bribes" is a stated sustainability goal
UNGC Signatory	UNGC

### Our view:

**The firm previously faced allegations related to UN Oil-for-Food Scandal in 2005<sup>73</sup>. Internal investigations verified there were no payments to the Iraqi government by Atlas Copco, according to a press release<sup>74</sup>. The current policies show a number of clear measures that strengthen the company's position.**

Source: Atlas Copco, Bloomberg, CA Cheuvreux

## Ansaldo STS

### ANSALDO STS

Risk Mitigation Profile	
Revenue reporting for higher risk regions (EUR)	FY 2011: ROW 6.2% EUR75.09m Asia Pac: 27.09% EUR328.29m
Holding structure	40% owned by Finmeccanica
Whistle-blowing	Non retaliation policy, Supervisory Body of the Code of Ethics receives reports, "dedicated information channel" allows internal reporting "in a confidential manner"
Reporting structure	"Special purpose Supervisory Body of the Code of Ethics"
Training	Training on Code of Ethics provided, no specific details on anti-corruption
Facilitation payments	No information found through publicly available sources
Zero tolerance	Code of Ethics states "Ansaldo STS prohibits all Recipients from accepting or offering money; gifts or undue favours"
UNGC Signatory	UNGC Signatory

#### Our view:

The current investigation against ENI and Saipem includes Ansaldo STS, which is alleged to have paid bribes to obtain Iraq and Kuwait oil field subcontracts<sup>75</sup>. Ansaldo STS guidance on gifts, benefits, promises of favours and political organisations is a step forward for a company of this size (market cap EUR1,044m) but the latest case shows application of policies may need enforcement.

Source: Ansaldo STS, Bloomberg, CA Cheuvreux

## Rexel

### REXEL

Risk Mitigation Profile	
Revenue reporting for higher risk regions (EUR)	2011: Asia Pac 10.05% EUR1,278m ROW 2.43% EUR308.9m Analyst estimate: 5% emerging markets revenue in FY 2011 Company annual report states it is "stepping up the acquisition strategy by intensifying its presence in China and setting up operations in India and Brazil".
Notable policy elements	Trading partners and suppliers "expected" to follow Rexel's Ethics Guide
Whistle-blowing	Internal network of "Ethics Correspondents" in all operating countries available who can receive requests anonymously with non reprisal policy. The annual report shows two anti-corruption requests made out of a total of 38 ethics cases. Anonymous contact form on website.
Reporting structure	No information found through publicly available sources
Training	Ethics workshops
Facilitation payments	US Code of Conduct document states these are "strongly discouraged"
Zero tolerance	Ethics Guide "rejects corruption in all its forms"
UNGC Signatory	Signed UNGC in December 2011

#### Our view:

No public investigations found at time of writing. Though emerging markets exposure is limited versus peers, we note new activities in China, Brazil and India as above.

Source: Rexel, Bloomberg, CA Cheuvreux

## Areva

### AREVA

Risk Mitigation Profile	
Revenue reporting for higher risk regions (EUR)	FY 2010 - Asia-Pacific: 16.99% EUR1,547m Africa/Middle East: 2.27 % EUR207m
Whistle-blowing	Non retaliation policy
Reporting structure	Science and Ethics Committee
Training	Overall ethics training programmes as part of Areva University and "Corporate Business Ethics Advisor"
Facilitation payments	No information found through publicly-available sources
Zero tolerance	"There is zero tolerance of corruption". Values Charter states "Areva prohibits corruption in any form whatsoever, whether public or private, active or passive."
UNGC Signatory	UNGC, EITI

#### Our view:

Areva's Bavarian offices were searched in April 2011<sup>76</sup>, and investigations were carried out on five employees and three consultants in relation to slush funds used for bribes between 2002 and 2005 according to a Bloomberg news story. However recent management changes and the creation of new supervision committees are potentially strong points. Areva states the company shall "do its utmost" to ensure regular suppliers to its core businesses and subcontractors/ financial partners/ consultants and commercial intermediaries subscribe to its Values Charter.

The Atomic Energy Commission holds 73% of the company, the French State 10.2%, and the Kuwait Investment Authority 4.8%

Source: Areva, Bloomberg, CA Cheuvreux

## Legrand

### LEGRAND

Risk Mitigation Profile	
Revenue reporting for higher risk regions (EUR)	FY 2011 – ROW 25.07% EUR1,065.5m Italy 15.57% EUR661.7m
Whistle-blowing	Matters reported through internal management have a non-retaliation policy
Reporting structure	No information found through publicly-available sources
Training	Generic Training on Charter of Fundamental Principles provided, no specifics on anti-corruption
Facilitation payments	No information found through publicly-available sources
Zero tolerance	No information found through publicly-available sources
UNGC Signatory	UNGC Signatory

#### Our view:

Though there is a lack of public disclosure on corruption policy details and systems, we found no current reported cases against the company.

Source: Legrand, Bloomberg, CA Cheuvreux

## VIII – Aerospace & Defence

### RISK PROFILE FOR THE AEROSPACE AND DEFENCE SECTOR

Aerospace and Defence	
Risk level	Very high
Key factors	High-value government contracts, political protection, use of intermediaries, emerging markets exposure
Well positioned	No overall top pick

Source: CA Cheuvreux

#### National interest – at what cost?

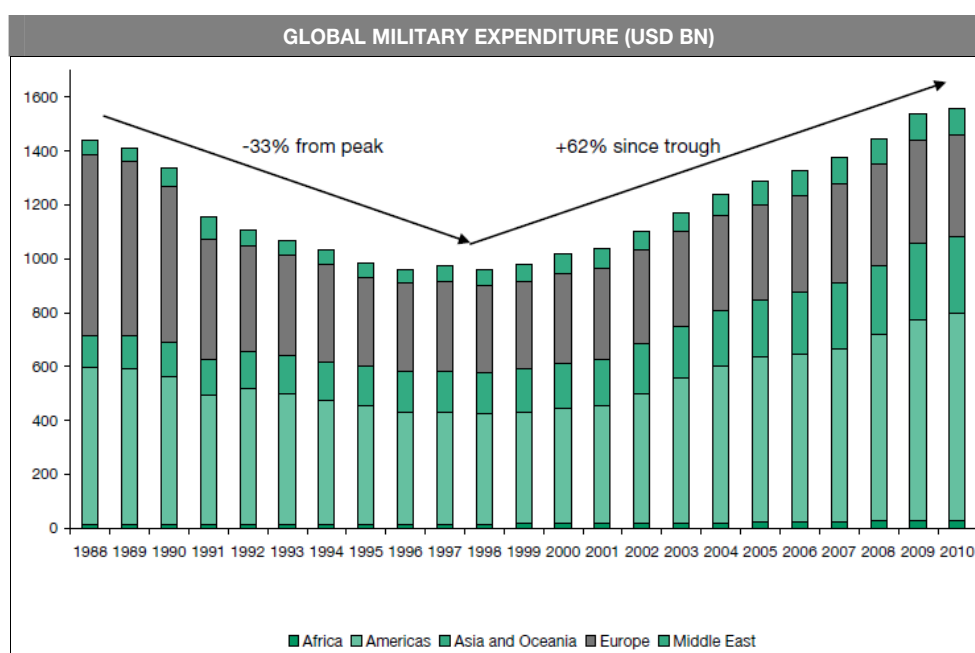
■ This industry ranks second highest in the Transparency International survey for high-level corruption or "Political Capture" behind banks. Not only is lobbying extremely strong but governments will often have major holdings in their countries' most important defence companies and also be important sources of revenue.

■ A characteristic of defence firms are government holdings; hence in cases where penalties are applied, States can become liable for part of the penalties and the reputational impact can extend to both the State and official parties involved. The industry is also marked by another factor: a significant amount of **political protection** marked by secrecy on the grounds of "national interest".

■ Defence companies are able to lobby strongly on a number of grounds including potential job losses if pursued by governments

■ The industry body "Aerospace & Defence Industries Association of Europe" (ASD) produces the ASD Common Industry Standards for Anti-Corruption and promotes good practices.

■ Geographically, we note that it is that defence budgets in emerging markets are rising at the fastest rate; therefore, exposure to countries with the highest corruption ratings is also growing.



Source: SIPRI

### A well-known case of political protection

## BAE Systems

The new UK Bribery Act is seen by some as being in part a response to the legal difficulties of enforcing stricter penalties in the BAE Systems case in Britain. The case was pivotal and puts it into the top 10 of highest ever penalties paid.

However, after the scandal, BAE now has a vastly tightened policy in place – which is best practice in some areas such as in policies on facilitation payments.

A Serious Fraud Office investigation started in the UK in 2004 over allegations that the company ran a slush fund used particularly for Saudi contracts; however, though the investigation continued, by 2006 **prime minister Tony Blair put pressure on the SFO to drop** the charges due to national security reasons. It is also alleged that Saudi Arabia threatened to withdraw counter-terrorism cooperation if the probe continued. The SFO stopped this investigation. BAE Systems finally reached a settlement in 2010 with US authorities for over GBP250m. The UK SFO had attempted a GBP1bn fine but ultimately ended up with GBP30m, totalling GBP286m penalties overall for BAE Systems.<sup>77</sup>

In the final FCPA judgement, no admission of wrongdoing was made, there were only settlements for bribery-related offences such as failures in record keeping, and conspiring to make false statements.

A recent Memorandum of Understanding issued by the UK SFO in March 2012 states BAE Systems will pay GBP29.5m plus accrued interest for educational projects in Tanzania.<sup>78</sup> It had faced allegations of hidden payments related to air traffic control and radar mechanisms dating back to 2002.<sup>79</sup>

Allegations by UK newspaper *The Guardian* surfaced in 2005 when it was alleged that offshore accounts had been used to make undisclosed payments to Pinochet in Chile.<sup>80</sup>

## BAE SYSTEMS

Risk Mitigation Profile	
Revenue reporting for higher risk regions (GBP)	FY 2010: Saudi Arabia 14.19% GBP2,994m Rest of Europe 9.65% GBP2,036m Africa, Central & South America 1.22% GBP257m Asia Pac 1.22% GBP257m
Notable policy elements	Independent Corporate Monitor in place from 2010 for up to three years following US settlement Responsible Trading Principles will have additional guidance on anti-bribery UK Bribery Act considered in Policies
Whistle-blowing	Whistle-blowing implemented, anonymous, open to third parties
Reporting structure	Corporate Monitor reports to the Board & US Department of Justice Group Chief Compliance Officer introduced in 2009, reporting to the Board of Directors
Training	Over 50% employees completed 2010 Anti-Corruption Compliance programme Board level training Ethics included in new employee induction
Facilitation payments	"Our employees must not make facilitation payments of any kind or allow others to make them on behalf of BAE Systems"
Zero tolerance	Zero tolerance policy available on external website
UNGC Signatory	UNGC Signatory

### Our view:

**After major 2010 settlements in the UK and the USA, BAE now has vastly tightened policies in place – which is best practice in some areas such as in policies on facilitation payments.**

Source: BAE Systems, Bloomberg, CA Cheuvreux

### Fallout from corruption included the resignation of its chairman

## Finmeccanica

Company chairman Pier Francesco Guarguaglini resigned in November 2011 during a major corruption investigation.

Mr Guarguaglini was accused by the Italian media of making illicit payments to politicians. There were allegations of systematic bribery of the Civil Aviation Authority by the company's Selex unit<sup>81</sup>, whose management included Mr Guarguaglini's wife. We note that Mr Guarguaglini denies the allegations.

Bloomberg and other news agencies reported that at end February 2012 the Indian authorities began investigations into bribery over a contract for 12 Agusta Westland helicopters valued at EUR560m. The company has denied all allegations in a press release.

The company states that India is "a priority market" and that it has an expected order intake from this country of EUR500m over 2011-2015. The possible fallout for Finmeccanica is therefore that future business in the country is at stake.

A recent story in a Milan newspaper on 25 February 2012) also reported bribery allegations in Canada regarding AW-139 helicopters sold to specialised transportation company Ornge<sup>82</sup>.

## FINMECCANICA

Risk Mitigation Profile	
Revenue reporting for higher risk regions (EUR)	FY 2010 : Italy 20.27% EUR3,790m ROW 17.67%, EUR3,304m
Holding structure	32.45% owned by Italian State as of 29 November 2011
Whistle-blowing	Non-retaliation policy, "Surveillance Body" receives claims, dedicated email address available
Reporting structure	No information found through publicly-available sources
Training	No information found through publicly-available sources
Facilitation payments	No information found through publicly-available sources
Zero tolerance	All acceptance or offering of "Gifts, benefits and promises of favours... in view of obtaining undue services" prohibited in Code of Ethics
UNGC Signatory	No

### Our view:

As noted above, the company has been the subject of corruption allegations in Italy and in India. Internally the use of "Consultants and Business Promoters" in countries with a high risk of corruption carries a red flag in risk assessments. Though a whistle-blowing policy exists, overall anti-corruption systems and disclosure could be made more detailed and robust.

Source: Finmeccanica, Bloomberg, CA Cheuvreux

## EADS

The *New York Times* and other papers reported in June 2011 that the UK Serious Fraud Office was investigating allegations of the bribery of Saudi officials to win a USD3.3bn contract. It was also alleged in May 2011 that the firm presented gifts of excessive value such as cars and jewellery as well as cash to obtain a GBP2bn communications contract.<sup>83</sup>

In the following case concerning EADS, we note that no official allegations of bribery took place (source: AFP).

### EADS and India

In December 2007, the Indian government halted talks for a USD600m contract for 197 EADS Eurocopter helicopters and a fresh tender was announced after accusations of irregularities in the procurement process.<sup>84</sup> Of interest is that the Indian government had banned the use of middlemen in procurement. According to AFP reports that we cannot confirm, one reason for this was the alleged use of an agent by EADS during the bid. The

illustration here is a complex one, for when bids are dropped they are rarely accompanied by full explanatory statements with evidence by authorities. They may be motivated by a variety of irregularities that are not exclusively linked to corruption. We note also that parties hostile or competing with EADS may be able to distort media claims against the company for their own interests, and we do not discount that this may have taken place.

However, in our view, if (as is the case for defence procurement in India) the mere possibility of use of an agent potentially puts large-scale contracts at risk, this illustrates the importance of robust publicly-declared policies, and accompanying enforcement to ensure such events are minimised. Going forward, we also note the UK legal requirement to have adequate policies in place.

Notably, the events with EADS in India occurred after "exclusive talks" status had already been announced (the same contract status that French group Dassault Aviation – partly owned by EADS – declared with the Indian military for a USD10bn deal for 126 fighter jets in February 2012).

## EADS

Risk Mitigation Profile	
Revenue reporting for higher risk regions (EUR)	FY 2010: Asia/Pac: 24.8%, EUR11,335m Middle East: 13.65%, EUR6,247m LatAm 5.55%, EUR2,537m
Holding structure	DaimlerChrysler Aerospace 22.33%, SOGEADE 22.33% (Lagardère and French government)
Notable policy elements	Anti-bribery provisions extend to suppliers
Whistle-blowing	"OpenLine" externally maintained with non retaliation but <i>not</i> anonymous. "Users of the alert system will be required to identify themselves to the service provider". Open to employees in France, Germany, Spain, and the UK only
Reporting structure	Chief compliance officer reports to CEO and audit committee
Training	Training in place, no further details
Facilitation payments	Prohibited
Zero tolerance	EADS "prohibits all forms of corruption whether public or private"
UNGC Signatory	UNGC Signatory

### Our view:

**UK probe continues surrounding a USD3.3bn contract for the Saudi National Guard involving GPT Special Project management<sup>85</sup>. Further details on the enforcement of policies regarding associates and partners are relevant. Areas of anti-corruption systems including whistle-blowing could be strengthened according to publicly-available details.**

Source: EADS, Bloomberg, CA Cheuvreux

## Rolls-Royce

### ROLLS-ROYCE

Risk Mitigation Profile	
Revenue reporting for higher risk regions (GBP)	FY 2011: Middle East & South East Asia 15.98% GBP1,778m China 8.4% GBP934m Africa 2.35% GBP261m South Korea 1.89% GBP210m Italy 1.65% GBP183m Russia 1.29% GBP143m
Notable policy elements	Risk assessment (by country)
Whistle-blowing	Anonymous third-party maintained hotline, with non-retaliation policy
Reporting Structure	Ethics committee reports to the Board
Training	Training in place, no further details
Facilitation payments	Prohibits facilitation payments: "does not condone the making of facilitation payments"
Zero tolerance	Code of conduct "prohibits the giving or receiving of any form of bribe"
UNGC Signatory	UNGC Signatory

#### Our view:

Requires intermediaries to comply with Code of Conduct. The company claims to have ethics due diligence on intermediaries. Although the firm's policies are strong there is a 20% defence aerospace exposure. The JV Tognum faced bribery allegations in South Korea in 2011 according to Bloomberg News - the country accounted for 1.89% of revenue in FY 2011 (3.2% in FY 2010).<sup>86</sup>

Source: Rolls-Royce, Bloomberg, CA Cheuvreux

## Safran

### SAFRAN

Risk Mitigation Profile	
Revenue reporting for higher risk regions (EUR)	FY 2011: ROW: 8.71% EUR1,022m Asia: 15.52% EUR1,821m
Whistle-blowing	No information found through publicly-available sources
Reporting structure	No information found through publicly-available sources
Training	No information found through publicly-available sources
Facilitation payments	No information found through publicly-available sources
Zero tolerance	Group ethical guidelines: "Zero tolerance of corruption...active or passive, direct and indirect...public or private sector"
UNGC Signatory	No

#### Our view:

Although guidance is given on gifts and hospitality, together with a strong zero tolerance policy there are weaknesses in overall reporting. The company faced official allegations from a legacy case that Sagem employees were involved in USD2m payments to Nigerian officials for a national ID card scheme worth EUR163m according to sources including Dow Jones Newswires.<sup>87</sup>

The French State holds 30.19% and Areva approx. 2% of exercisable voting rights

Source: Safran, Bloomberg, CA Cheuvreux

## Thales

It was announced in 2010 that Thales was to be fined around EUR630m (of which a significant part was interest), awarded to the Taiwanese State for the sale of frigates to Taiwan in 1991 in a case involving intermediaries<sup>88</sup>. In a press release issued May 2010 the company stated "Thales disputes the very grounds of this decision"<sup>89</sup>.

Thales was also debarred by the World Bank in 2005<sup>90</sup> for a year for fraudulent practices related to Cambodian military contracts.

The company was reportedly the subject of allegations in South Africa in 2005 for bribes to Jacob Zuma in relation to navy contracts<sup>91</sup>. The company denies the allegations.

### THALES

Risk Mitigation Profile	
Revenue reporting for higher risk regions (EUR)	FY 2011: Asia Pac 14.19% EUR1,849m Middle East 7.27% EUR947m Africa and Latin America 4.66% EUR607m
Notable policy elements	Includes UK Bribery Act Guidance, policy on employing business advisors which includes third party checks, applies provisions to suppliers
Whistle-blowing	"EthicsAlert", not anonymous but protected by a confidentiality agreement
Reporting structure	The Ethics and Corporate Responsibility Committee reports to Audit and Internal Control
Training	Variety of optional and compulsory schemes: 18.2% of employees completed three 30-minute modules. Four-hour face to face training to be completed by 3,500 from 2010 to 2012 and 4,000 scheduled for 2013-14
Facilitation payments	Thales "does not condone the making of facilitation payments"
Zero tolerance	"Zero tolerance for corruption"
UNGC Signatory	UNGC Signatory, ASD, International Chamber of Commerce Anti-Corruption Task Force

#### Our view:

**Lack of anonymity in the whistle-blowing policy is a potential weak point in an otherwise strong set of systems. The Taiwanese frigate case has been ruled on and ended with indications that the company has moved forward in implementing stronger anti-corruption culture with no new cases emerging in recent years. We would welcome further information on enforcement of policies both internally and with suppliers.**

**Voting rights: 42% French State, 20% Dassault Aviation**

Source: Thales, Bloomberg, CA Cheuvreux

## Mid Caps

### Zodiac Aerospace

### ZODIAC AEROSPACE

Risk Mitigation Profile	
Revenue reporting for higher risk regions (EUR)	FY 2010: "Rest of World", i.e. excluding both Americas & Europe 21.38% EUR459.64m
Supplier policy	No information found through publicly-available sources
Whistle-blowing	No information found through publicly-available sources
Reporting structure	No information found through publicly-available sources
Training	No information found through publicly-available sources
Facilitation payments	No information found through publicly-available sources
Zero tolerance	No information found through publicly-available sources
UNGC Signatory	No

#### Our view:

**A lack of any disclosed policies or systems in a context of acquisitions is a weakness, though only 5% revenues are generated in the defence segment. Growing civil sector exposure in emerging markets.**

Source: Zodiac Aerospace, Bloomberg, CA Cheuvreux

## Cobham

### COBHAM

Risk Mitigation Profile	
Revenue reporting for higher risk regions (GBP)	FY 2011: ROW 9.24% GBP171m
Whistle-blowing	Anonymous third-party maintained hotline, with non-retaliation policy
Reporting structure	Business Ethics & Compliance Committee reports to the Board
Training	Face to face, online and non-English ethics training in place
Facilitation payments	No information found through publicly-available sources
Zero tolerance	Code of Conduct contains detailed statement
UNGC Signatory	No

**Our view:** Well positioned: Strong policies for a mid cap, no current cases.

Source: Cobham, Bloomberg, CA Cheuvreux

## MTU Aero Engines

### MTU AERO ENGINES

Risk Mitigation Profile	
Revenue reporting for higher risk regions (EUR)	FY 2011: Asia 7.19%, EUR210.9m South America 3.04% EUR89m Africa 0.25% EUR7.2m
Whistle-blowing	Independent "Ombudsman" has been appointed, no further info
Reporting structure	No information found through publicly-available sources
Training	No information found through publicly-available sources
Facilitation payments	No information found through publicly-available sources
Zero tolerance	Bribery "disallowed" with detailed guidance
UNGC Signatory	UNGC Signatory

**Our view:** A UNGC signatory which is promising for a mid cap, bribery prevention guidance is contained in the Code of Conduct.

Source: MTU, Bloomberg, CA Cheuvreux

## Rheinmetall

### RHEINMETALL

Risk Mitigation Profile	
Revenue reporting for higher risk regions (EUR)	FY 2010: Asia: 12.76% EUR509m Rest of World (excl. Europe, Asia, North America): 7.24%, EUR289m
Whistle-blowing	No whistle-blowing, only "confidential" internal reporting to managers
Reporting structure	No information found through publicly-available sources
Training	Training provided but no details
Facilitation payments	No information found through publicly-available sources
Zero tolerance	No information found through publicly-available sources
UNGC Signatory	No

#### Our view:

**Air Defence division allegedly banned for ten years from Indian government defence procurement though the company is contesting the claim and denies all wrong doing.<sup>92</sup> Whilst not currently considered financially material (India <1% revenue), this is bad news as future revenues from one of the fastest-growing defence markets is blocked. Overall, the anti-bribery policy disclosure is weak.**

Source: Rheinmetall, Bloomberg, CA Cheuvreux

# Notes

End notes, references & web links

<sup>1</sup> <https://www.ethics.org/files/u5/LRNEmployeeEngagement.pdf>

<https://gsbapps.stanford.edu/researchpapers/library/RP1805.pdf>

<sup>2</sup> <http://www.sec.gov/news/press/2012/2012-25.htm>

<sup>33</sup> <http://secfilings.nyse.com/filing.php?doc=1&attach=ON&ipage=7207967&rid=23>

Extract from Avon SEC Filing 2010: "The increase in Net Global expenses for both the three and nine months ended September 30, 2010, was primarily attributable to significant professional and related fees associated with the FCPA investigation and compliance reviews described in Note 5 to the consolidated financial statements included herein of approximately \$24 (up approximately \$17 from the three months ended September 30, 2009) and approximately \$72 (up approximately \$49 from the nine months ended September 30, 2009), respectively. The increase in Net Global expenses for the nine months ended September 30, 2010 was also due to higher costs associated with global initiatives and costs associated with business acquisitions. Professional and related fees associated with the FCPA investigation and compliance reviews, while difficult to predict, are expected to continue during the course of this investigation"

<sup>4</sup> <http://www.sec.gov/news/press/2008/2008-294.htm>

<sup>5</sup> <http://www.sec.gov/news/press/2010/2010-258.htm>

<sup>6</sup> <http://web.worldbank.org/external/default/main?theSitePK=84266&contentMDK=64069844&menuPK=116730&pagePK=64148989&piPK=64148984>  
<http://web.worldbank.org/external/default/main?theSitePK=84266&contentMDK=64069844&menuPK=116730&pagePK=64148989&piPK=64148984>

<sup>7</sup> <http://web.worldbank.org/WBSITE/EXTERNAL/NEWS/0..contentMDK:22563910~pagePK:34370~piPK:34424~theSitePK:4607,00.html>

<http://www.guardian.co.uk/global-development/2011/jul/25/macmillan-education-deal-south-sudan>

<http://www.reuters.com/article/2010/05/05/us-sudan-publisher-idUSTRE64429T20100505>

<sup>8</sup> <http://www.siemens.com/press/pool/de/events/2011/corporate/2011-q1/2011-q1-legal-proceedings-e.pdf>

<sup>9</sup> <http://siteresources.worldbank.org/PROCUREMENT/Resources/SiemensFactSheetNov11.pdf?resourceurlname=SiemensFactSheetNov11.pdf>

<sup>10</sup> <http://frontierindia.net/indiandefence/rheinmetall-air-defence-rejects-ofb-corruption-allegations/>

<http://expressbuzz.com/thesundaystandard/defence-delayed-is-defence-denied/377869.html>

<http://www.rapidbing.com/india-banned-companies-arms-scandal-brobbery/>

<sup>11</sup> <http://caselaw.findlaw.com/us-dc-circuit/1498811.html>

<sup>12</sup> [http://markets.on.nytimes.com/research/stocks/news/press\\_release.asp?docTag=201203301734BIZWIRE\\_USPRX\\_BW5993&feedID=600&press\\_symbol=46227](http://markets.on.nytimes.com/research/stocks/news/press_release.asp?docTag=201203301734BIZWIRE_USPRX_BW5993&feedID=600&press_symbol=46227)

<sup>13</sup> [http://securities.stanford.edu/1044/SI00\\_01/index.html](http://securities.stanford.edu/1044/SI00_01/index.html)

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