

# Corruption

Sarasin & Partners Responsible Investment Research

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Sarasin & Partners has researched and written this paper as one of a series which considers the investment implications of environmental, social and governance issues. This research is written from an investment perspective; it aims to inform investment judgements and to identify how investors can contribute to more sustainable investment returns achieved in a way that respects the well-being of society and the environment.

## Corruption

### Introduction

In an increasingly global economy, multinational companies often operate in countries which vary in the extent of corruption, cultural attitudes towards corruption, and the legal environments to address it. However, with legislation against corruption tightening, both internationally and in many individual countries, companies' handling of potential corruption risks is increasingly under scrutiny. When companies are charged with corruption it can have significant implications for their financial and investment performance.

When evaluating potential investments that are exposed to corruption risks, or current investments affected by corruption, investors need to consider the scale of corruption, whether it is likely to reoccur, and what actions it is appropriate for them, as investors, to take.

To inform these decisions, this paper starts by defining corruption and summarising the legal position on corruption. Following an overview of current trends in corruption and moves to counter it, the impacts of corruption are considered at three levels: financial impacts on individual companies, wider economic impacts, and wider non-economic impacts.

### Definition

The World Bank's definition of corruption is clear and widely recognised; corruption is "the abuse of public office for private gain."<sup>1</sup> This definition therefore covers public sector corruption, when a public official accepts, solicits or extorts a bribe. It also covers private sector corruption, if, for example, a company offers a bribe to circumvent public policies and gain competitive advantage. Corruption includes a range of different activities such as theft, bribery, diversion of state revenues, and political corruption.

Corruption is distinct from fraud. While the specific legal definitions of fraud vary between countries, it can be broadly defined as intentional deception made for personal gain or to damage another individual.

### Legal Position

Every country has rules against corruption, but these vary in their comprehensiveness and level of enforcement. Corruption legislation from a number of countries can consider a company's activities abroad. For example companies listed in the US can be prosecuted under the Foreign Corrupt Practices Act (1977) (FCPA) even if the corruption occurred outside the US. The Bribery Act (2010) takes a similar position with respect to the UK.<sup>2</sup>

Surprisingly, a number of developed countries have been slow to adopt tough anti-bribery legislation. For example, there was no specific legislation against the tax deductibility of bribes to foreign officials in countries including Australia, France, Italy, and Spain until 2000. Similarly, 'facilitating payments' (payments made to expedite or to secure the performance of a routine governmental action), are legal in the US under the FCPA,<sup>3</sup> but no longer expressly legal in the UK.

At the international level there are a number of conventions on corruption, particularly the OECD Convention On Corruption (entered into force in 1999) and the UN Convention Against Corruption (entered into force in 2005). These conventions are ambitious, and include preventive measures to be adopted by Governments and criminalization of corruption across public and private sectors. Their uptake by major economies has however not been universal, and it remains the case that "the actual enforcement of prohibitions against corruption is usually the most difficult step."<sup>4</sup>

In addition to the formal legislation against corruption, there are number of voluntary codes to which multinational companies can sign up, such as the OECD Guidelines for Multinational Enterprises and The Global Compact which encourage companies to adopt practices that will reduce corruption.

There is generally a move to tighten anti-corruption legislation in both developed countries and the emerging economies. For example, the UK Bribery Act 2010, which came into force on 1 July 2011, has stricter penalties against corruption than previous UK legislation. China's anti-corruption laws are now some of the most severe in the world, but they predominantly apply domestically and Chinese authorities have yet to introduce comparable legislation for Chinese companies operating abroad.

### Current Trends

According to Transparency International (TI), an NGO which specialises in identifying and tackling corruption, a 2010 global public opinion survey reveals a perception that on the whole corrupt practices are on the rise.<sup>5</sup> The risk of corruption in the business / private sector is, however, perceived to be relatively lower than in the political and public sectors (see Appendix 1).

The risk of corruption varies significantly though between industries and countries. Corruption is more likely in situations where public officials:

- control large contracts and financial flows,
- enjoy significant discretion over the allocation of contracts and

- financial flows,
- face low accountability for their actions and decisions.<sup>6</sup>

This helps to explain, for example, why corruption risks are relatively higher in natural resources industries (where multi-million dollar contracts abound), transitional economies (where property rights over formerly state-owned assets can be opaque), and in some developing countries (where public officials can face lower accountability due to less established governance institutions and less active civil society).

In some sectors which have been tarnished by corruption, there have been initiatives to reduce the likelihood of it reoccurring. The “Extractive Industries Transparency Initiative” (EITI) for example, launched in 2002, is a “coalition of governments, companies, civil society groups, investors and international organisations” that

“aims to strengthen governance by improving transparency and accountability in the extractives sector”.<sup>7</sup>

#### Case Studies: Incidents and outcomes

Companies may be able to increase their financial performance, and therefore valuation, by engaging in corruption. Their actions may go undetected, sometimes for many years, leading investors to believe that value is being sustainably and legitimately created.

On the other hand, an investigation into corruption may lead to legal fees, fines or settlement costs, and even individual legal implications for members of senior management. Set out below are several examples of situations in which companies have been investigated for corrupt practices, including a description of what happened and the outcome for the company. Finally, investment impact is discussed.

What happened	Outcome for company
<p><b>Avon</b> In 2008 Avon announced an internal investigation into possible violations in China of the FCPA. In July 2009 Avon announced the investigation was being expanded to additional countries. In April 2010 four senior managers from Avon's China business were suspended.</p>	<p>The investigation is ongoing.</p> <p>Avon reported that it spent \$96 million on the investigation in 2010, \$35 million the year before, and expects this year's costs to be similar to those in 2010.<sup>8</sup></p>
<p><b>BAE Systems</b> In July 2004 the UK Serious Fraud Office (SFO) announced an investigation into the “Al Yamamah” deal for aircraft between BAE Systems and Saudi Arabia, the UK's largest ever export contract. In December 2006 the SFO dropped the Al Yamamah case. However in February 2007 the SFO confirmed six concurrent corruption investigations into BAE Systems and in June 2007 the US Department of Justice (DoJ) launched its own inquiry into the company's activities. Settlement with the UK and US investigators was reached in 2010.</p>	<p>BAE's settlements amounted to \$450 million in fines to the DoJ and the SFO. BAE had pleaded guilty to minor accounting charges, but did not admit to bribery, which would have prevented it from bidding for future defence contracts in the US and Europe.<sup>9</sup></p>
<p><b>Daimler AG</b> In 2004 an employee of Daimler claimed that he had been fired for voicing concern about secret accounts maintained to pay bribes. In October 2004 the company announced that the US Securities and Exchange Commission (SEC) had initiated an investigation, under which Daimler was subsequently charged with paying tens of millions of dollars of bribes to foreign officials in more than 22 countries to secure government contracts.</p>	<p>Daimler paid \$91 million to settle the SEC charges. It paid a further \$93.6 million to the DoJ in separate criminal proceedings.</p>
<p><b>Hewlett-Packard</b> On 15 April 2010 the company announced that German and US authorities had launched investigations into whether the company had paid \$11 million in bribes to Russian government officials to win contracts.</p>	<p>The investigation is ongoing.</p>
<p><b>Johnson &amp; Johnson</b> On 19 February 2007 the worldwide chairman of Johnson &amp; Johnson's (J&amp;J's) medical devices business abruptly stepped down when J&amp;J disclosed that foreign subsidiaries may have made improper payments in the course of marketing activities. J&amp;J was subsequently charged with bribing doctors in Europe (a sum of \$7 million was involved) and running a kickback scheme under the UN Oil for Food programme in Iraq.</p>	<p>J&amp;J agreed to pay \$78 million in fines to the US DoJ, SEC, and the UK SFO to settle the investigations. A British senior executive was sentenced to 12 months imprisonment for his role in paying bribes to Greek doctors.<sup>10</sup></p>
<p><b>JV including Halliburton, ENI, Kellogg Brown &amp; Root (KBR) Inc, Technip</b> On 11 June 2004 the US DoJ and SEC launched investigations under the FCPA, alleging that between 1995 and 2002 agents of the JV gave bribes of \$180 million to Nigerian officials to win contracts worth over \$6 billion to build liquefied natural gas (LNG) plants.</p>	<p>On 11 February 2009 Halliburton and KBR agreed to pay a penalty of \$579 million, the second largest settlement in a FCPA case after the Siemens settlement in 2008. In June 2009 Technip agreed to pay a fine of \$338 million.</p>

## What happened

### Siemens

In 1992 Siemens bribed a German public official to win a large electronics contract for a public sewage treatment plant.

In 1996 Siemens paid a \$9.8 million bribe to a Singaporean public official to gain access to confidential information on utilities tenders.

In 2007 Siemens was found guilty in Italy of bribing employees of state-owned Enel to secure a contract for gas turbines.

Full investigations by US and German authorities into corruption at Siemens began in late 2006. According to the SEC, the "pattern of bribery by Siemens was unprecedented in scale and geographic reach."

### Titan Corporation

In 1998, the Titan Corporation commenced a wireless telephone network construction and operation project in the West African country, Benin, for which it received compensation including a management fee worth millions of dollars.

From 1999 to 2001, Titan paid more than \$3.5 million to an agent in Benin acting as the President of Benin's business advisor. It contributed about \$2 million of this sum to the President's re-election campaign. Titan made the payments in order to assist the progress of its telephone network development project, and to encourage Benin to increase the management fees for the project.<sup>12</sup>

Both the DoJ and SEC investigated Titan's activities from early 2004. The SEC found that in addition to the main Bribery scandal in Benin, Titan systematically falsified reports or underreported local commission payments in its operations around the world.

In March 2005, Titan pleaded guilty to the offences alleged by the DoJ, and agreed to a settlement with the SEC.

## Outcome for company

Siemens faced fines totalling \$1.3 billion in the US and Germany, and disgorgement fees of €38 million in Italy. The total cost to Siemens, including legal and accounting fees, was estimated at \$3.3 billion.<sup>11</sup>

In addition, Siemens was barred from public tenders in Singapore for 5 years, and from entering into negotiations with Italian public administration for a year.

In 2005, Titan paid a total of \$28.5 million in fines and for a civil settlement.

In addition, the bribery investigation appears to have contributed to the Lockheed Martin Corporation's decision to terminate its agreement to acquire Titan in 2004.<sup>13</sup> In 2003, Lockheed offered to buy Titan for \$1.8 billion. When the DoJ and SEC commenced investigations into Titan in early 2004, Lockheed lowered its buying price to \$1.6 billion and gave Titan a deadline of 25 June 2004 to satisfy the investigators. When this did not happen, Lockheed terminated the agreement.

## Investment impact of corruption

A review of the change in share price in these companies suggests that corruption and investigations into corrupt practices may impact upon investment performance. The extent and nature of this impact appears to differ from case to case. For BAE, the announcement \$450 million in fines in February 2010 correlated with a sustained fall in share price relative to the Bloomberg EMEA Aerospace/Defence Index. However, government defence funding over this time is also a relevant consideration for BAE. By contrast, for J&J, the announcement of a \$78 million fine and the prison sentence handed down to a senior executive was accompanied by an increasing share price relative to the Bloomberg US Pharmaceuticals Index. For the Titan Corporation, the affects were more mixed: following the settlement of corruption charges, the share price increased relative to the Bloomberg EMEA Aerospace/Defence Index; at the same time, however, Lockheed Martin reported that Titan's corruption investigation was at the heart of its decision to terminate the companies' merger agreement.

As mentioned above, corruption may provide companies with business advantages. This may have been the case for the joint venture involving Halliburton, ENI, Kellogg Brown & Root (KBR) Inc and Technip. The eventual fines paid by the JV remain small (though not insignificant – about \$900 million shared across the JV) compared to the contracts won (\$6 billion). By contrast, the magnitude of Titan's fines (\$28.5 million) appears to be significant in relation to the bribery sums involved (\$3.5 million). In all of the

cases presented, other, less explicit costs, may arise as a result of the corruption investigations.

Finally, while in a number of cases, the announcement or findings of corruption investigations appear to correlate with short-term falls in share price, the long-term impacts on share price remain unclear.

## Wider Economic Impacts

A wide body of research has considered the economic impacts of corruption for individual countries and regions. The clear conclusion emerges that corruption restrains economic growth and restricts private investment by undermining the property rights, policies, public institutions, processes and values on which commerce depends. No credible politician, economist or investor argues that corruption is positive for economic development.

Transparency International's annual Corruption Perceptions Index indicates the relative extent of corruption in countries and regions worldwide (see Appendix 2). The drag of corruption on economic development in Africa is well recognised. Corruption is one of the factors which has hampered the establishment of well-functioning market economies in the former Soviet Union.

The World Bank recognises that the coexistence of high economic growth and systemic corruption in some Asian countries could be seen as a challenge to the belief that corruption is always economically harmful.<sup>14</sup> Other research, however, suggests that corruption may indeed be restraining growth in Asia.<sup>15</sup>

## Wider Non-Economic Impacts

In addition to hampering economic development, corruption also undermines the values and institutions that form the basis for many successful societies. Over time most developed countries have institutionalised in their political and commercial systems the values of trust, transparency, honesty, efficiency and equity. By eroding these values, corruption, in the words of the World Bank, “weakens the ethical fabric of civil society and prevents the emergence of well-performing government capable of developing and implementing public policies that promote social welfare.”

Flourishing public financial markets, from which investors benefit, rely on transparent and effective governance and institutions. Investors collectively and individually therefore have a responsibility to contribute to the reduction of corruption.

## Implications for investors

While investors vary in the duration of their investments and their objectives, all can contribute to the reduction of corruption through the due diligence they undertake before investing, how they fulfil their shareholder responsibilities when invested, and through supporting initiatives against corruption.

## Before Investing

During due diligence investors can assess the risks of corruption to potential investment opportunities, by considering the:

- relative risk of corruption in the industries and countries in which a company operates,
- company’s track record in corruption and internal controls to prevent it.

It is important during due diligence on corruption to note that:

- as shown by the repeated incidences of corruption at Siemens, despite senior management’s attempts to reduce the risk of re-occurrence, it often takes time and considerable effort to change a company’s values and processes; and
- compared to actions companies may take to tackle other social, environmental and governance issues, it is relatively harder to verify how effective anti-corruption measures are as corruption occurs in secret and is only brought to light after disclosures and investigations.

## When Invested

When investors have invested in a company they have ongoing responsibilities as shareholders, and have specific actions they can take to reduce the risk of corrupt activities occurring. On an ongoing

basis, shareholders can support initiatives and resolutions within companies that address corruption.

If significant corruption occurs or is suspected in a company in which an investor is invested, it will need to consider:

- whether the alleged corruption is a one-off or more systemic;
- the potential investment impact of the alleged corruption and, if appropriate, the reputational impact; and
- whether measures being taken by the management team and board to reduce the risk of corruption are sufficiently robust to avoid future re-occurrence.

Investors need to recognise that while legal investigations are ongoing, companies may be reticent to enter full and open discussions about any alleged corruption and measures they are taking to address it.

## Best practice for business initiatives

Investors may refer companies to a best practice initiative in order to tackle corruption. Various government initiatives, TI and the World Economic Forum all have released strategies designed to help businesses to avoid bribery and corrupt practices:

- TI’s series of “Business Principles for Countering Bribery“ have been adopted by a large number of multi-national corporations and provide a simple framework for addressing corruption, in which an enterprise commits to implementing a programme to counter bribery.<sup>16</sup>
- The World Economic Forum’s “Partnering Against Corruption Initiative” requires signatories to commit to having a zero tolerance policy towards bribery and to developing and implementing or maintaining a broad-based, anti-corruption programme. Unlike the TI initiative, it requires business to commit publicly to action.<sup>17</sup> Its signatories include BHP Billiton and Merck & Co.

## Supporting Anti-Corruption Initiatives

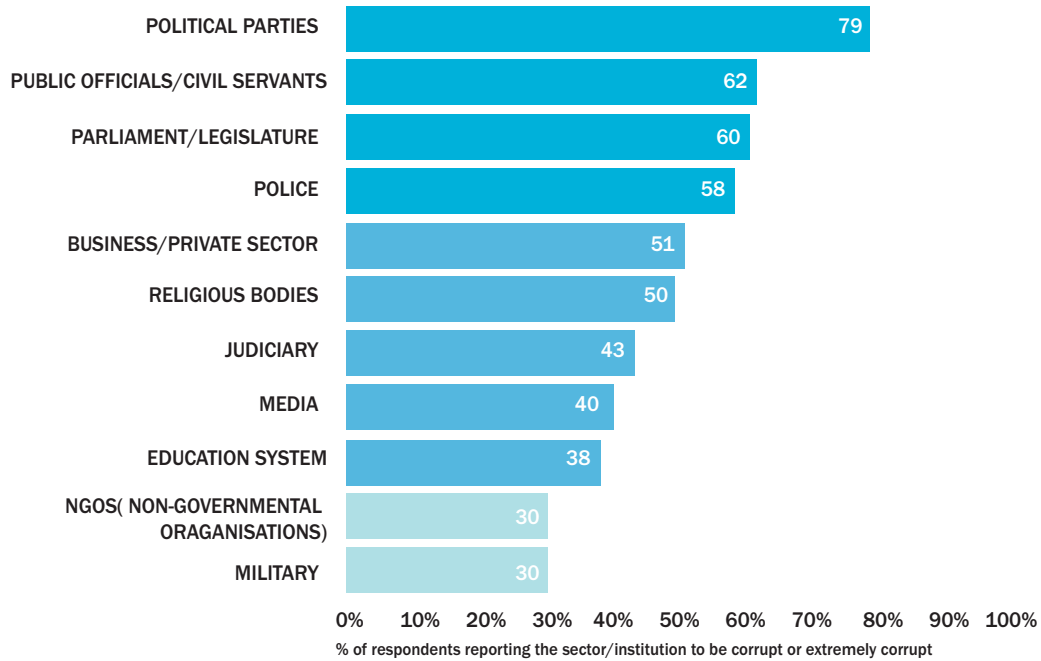
Individual investors have neither the resources nor expertise to take full responsibility for overseeing the anti-corruption processes of companies and actions they take should corruption occur. Collectively however investors can influence how companies tackle corruption. Investors should therefore support initiatives like the EITI and the International Corporate Governance Network which engage with industries and politicians to promote high governance standards, support anti-corruption measures, and encourage companies that are proactive in addressing corruption.

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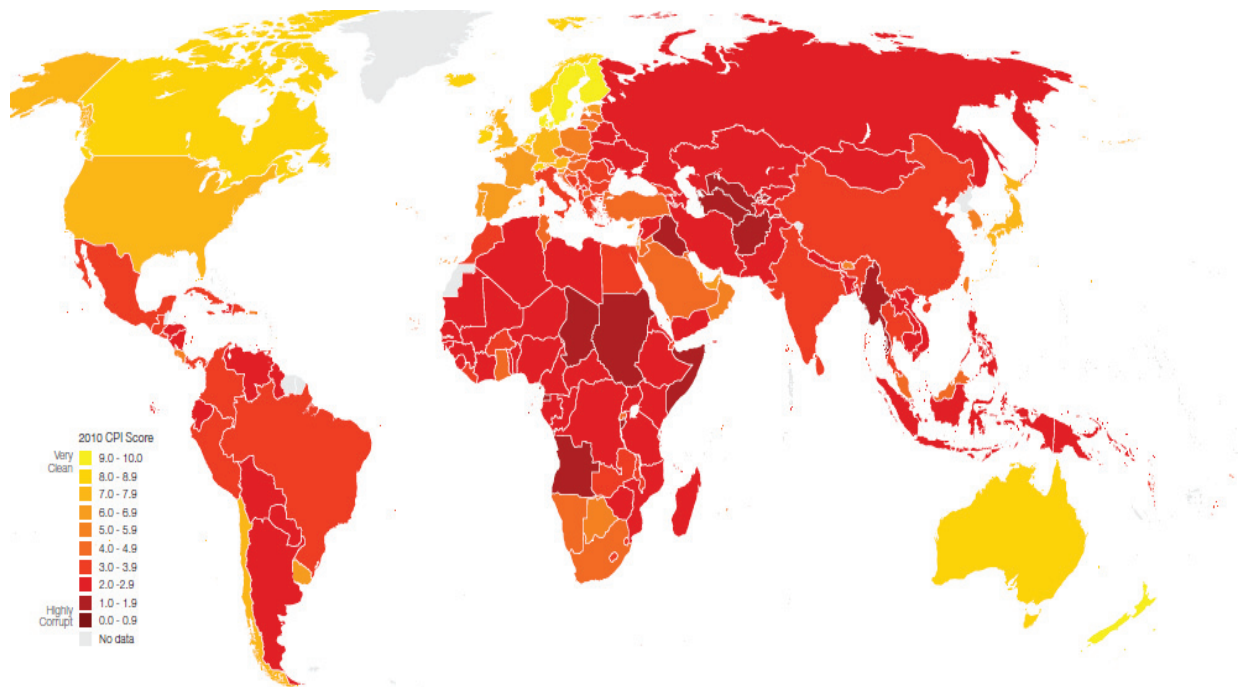
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**Appendix 1: Transparency International: Global Corruption Barometer 2010**



Source: [www.transparency.de/fileadmin/pdfs/Wissen/Korruptionsindices/GCB\\_2010.pdf](http://www.transparency.de/fileadmin/pdfs/Wissen/Korruptionsindices/GCB_2010.pdf)  
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**Appendix 2: Transparency International: Corruption Perceptions Index 2010**



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## Endnotes

- <sup>1</sup> See “Corruption and Economic Development”, World Bank. <http://www1.worldbank.org/publicsector/anticorrupt/corruptn/cor02.htm>
- <sup>2</sup> For example, section 7 of the Bribery Act (2010) (UK), which relates to the failure of commercial organizations to prevent bribery, applies to commercial organizations incorporated overseas but which carry on a business or a part of a business in any part of the UK
- <sup>3</sup> FCPA, § 78dd-1(b)
- <sup>4</sup> Fritz Heimann, Transparency International, “Making the United Nations Convention against Corruption Work”, in UN Global Compact, Business Against Corruption (2003).
- <sup>5</sup> “Global Corruption Barometer 2010”, Transparency International
- <sup>6</sup> See “Cleaning Up and Invigorating the Civil Service”, Robert Klitgaard, World Bank Operations Evaluation Department, November 1996
- <sup>7</sup> For further information see the EITI website: <http://eiti.org/eiti>
- <sup>8</sup> Ellen Byron, “Avon Bribe Investigation Widens”, Wall Street Journal, Business (5 May 2011)
- <sup>9</sup> David Robertson and Alex Spence, “Six-year BAE investigation ends with minor accountancy charges”, The Sunday Times (6 February 2010)
- <sup>10</sup> Serious Fraud Office, Press Release: “British executive jailed for part in Greek healthcare corruption,” (14 April 2010)
- <sup>11</sup> David Gow, “Record US fine ends Siemens bribery scandal”, The Guardian (16 December 2008)
- <sup>12</sup> US Securities and Exchange Commission, “SEC Sues the Titan Corporation for Payments to Election Campaign of Benin President”, Press Release 2005-23
- <sup>13</sup> Tim Weiner, “Titan Corp. to Pay \$28.5 Million in Fines for Foreign Bribery”, The New York Times (2 March 2005)
- <sup>14</sup> See “Corruption and Economic Development”, World Bank. <http://www1.worldbank.org/publicsector/anticorrupt/corruptn/cor02.htm>
- <sup>15</sup> “Corruption: The Facts”, Daniel Kaufmann, Foreign Policy, June 1997
- <sup>16</sup> Transparency International, Business Principles for Countering Bribery (2009)
- <sup>17</sup> World Economic Forum, Partnering Against Corruption Initiative: <http://www.schwabfound.org/en/initiatives/paci/index.htm>

Marketing Enquiries:

Tel: +44 (0)20 7038 7005

Fax: +44 (0)20 7038 6864

mail: [marketing@sarasin.co.uk](mailto:marketing@sarasin.co.uk)

Authorised and Regulated by the Financial Services Authority

Juxon House  
100 St. Paul's Churchyard  
London EC4M 8BU

Tel: +44 (0)20 7038 7000

Fax: +44 (0)20 7038 6850

[www.sarasin.co.uk](http://www.sarasin.co.uk)

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