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Advisory

Private equity spotlight

Anti-bribery and corruption: Implications for private equity

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Foreword

KPMG's recent global survey of corporate risk leaders, *Anti-Bribery and Corruption: Rising to the challenge in the age of globalization*, revealed an increasingly challenging environment for risk identification concerning anti-bribery and corruption (ABC). With more businesses operating across borders and a growing number of governments around the world highlighting ABC regulations and enforcement, our survey reveals that companies are focused on rising to the challenge. However, a great deal more needs to be done to create effective ABC structures to mitigate the very real risks that can destroy value and attract undesirable attention from regulators.

The findings from KPMG's 2015 survey are detailed in the full report. In this private equity (PE) spotlight article, we look at the implications for PE investors in Asia, with a particular focus on China. Moreover, we provide some relevant suggestions for PE firms regarding ABC compliance over the asset investment life cycle.

We would be delighted to discuss this spotlight article further. Please feel free to contact us, other Financial Services contacts listed in this article, or your usual KPMG contacts.

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Anti-bribery and corruption: Implications for private equity

One of the biggest challenges highlighted by respondents in the survey was the difficulty of conducting a due diligence analysis on foreign agents and third parties. This is a common concern expressed in China too. This is particularly relevant when a target entity or portfolio entity is not obligated to observe the same regulations as the investor and ultimate owner (e.g. the US Foreign Corrupt Practices Act (FCPA) or UK Bribery Act), or the entity has not sufficiently considered the strategic importance of China's efforts to strengthen transparency and stamp out corruption through its anti-corruption laws.

Inconsistencies or differing standards across jurisdictions also present risks. In addition, cultural differences can compound the compliance challenge, such as the reluctance by procurement teams or sales middle management to impose their company's ABC policies on third parties.

As the Chinese market becomes increasingly relevant to an organisation's overall revenue pie and as Chinese entities continue to expand internationally, policing authorities and prudent investors may no longer tolerate material differences or inconsistencies in the application of a company's ABC policies across jurisdictions. ABC policies should not be fragmented, and should not only be enforced in certain departments or regions. An enterprise risk management (ERM) approach should be in place to help ensure that ABC policies are implemented consistently across the organisation, and that they are tailored for and relevant to local market risks.

Questions to be considered by private equity fund managers

The application of an ERM approach for the PE sector should be conducted in a similar manner. The consistent application of ABC policies across the PE entities themselves, their affiliates and portfolio companies should be considered.

Pre-investment stage

When investing or looking at potential investment targets, these are some of the key questions PE firms or their advisors should include in their due diligence process, scope or investment analysis when looking to detect any risks or gaps associated with the target's ABC policies and procedures:

1

Does the investment target manage a sustainable revenue stream?

PE firms should have a thorough understanding of how the investment target obtains and retains its business, and should know the entities and individuals it interacts with in order to do so. Contracts obtained through inappropriate means may become legally unenforceable, and business obtained illegally will often be lost when the arrangements stop.

2

What ABC legislation is applicable to you and the investment target?

It is important for PE firms to identify the markets in which the investment target has operations, and the respective ABC legislation relevant to the investment target in each of these markets. PE firms should also consider the competence of target management and the level of maturity of the investment target's ABC policies and compliance programme, which would also impact asset valuation and investment risks.

3

In which industry is the investment target?

Have there been violations or enforcement actions in the same industry in the past? Certain industries, such as pharmaceuticals, healthcare, and energy and natural resources tend to be considered particularly high risk in the ABC arena. Given the inherent nature of these businesses (including frequent interactions with government officials and state-owned entities, and the common use of external consultants and third-party intermediaries) and the industry-wide enforcement campaigns implemented by the regulators, PE firms should pay particular attention to ensure that thorough due diligence procedures have been carried out as soon as practicable.

4

What do limited partners expect from PE funds, particularly in terms of environmental, social & governance policies and reporting?

Is the potential investment consistent with the fund's and your firm's own environmental, social & governance (ESG) policies? Limited partners (LPs) are increasingly looking to general partners (GPs) that can demonstrate a commitment to sound ERM, including an understanding of the LPs' own ESG policies. LPs will continue to gravitate towards those GPs which have implemented industry best practices and commonly accepted global standards surrounding private equity fund governance and key internal controls. Reporting is also critical; LPs will require value-added reporting over and above the fund's financial performance. Risk and related information (e.g. mitigation activities) that provides genuine insight into how GPs manage risk is also expected.

Post-investment stage – The first 180 days

The general principle is that a company assumes certain liabilities when merging with or acquiring another company. Where an acquirer purchases the seller's stock and integrates the investment target into its operations, successor liability may be conferred upon the acquirer's pre-existing criminal and civil liabilities. For PE firms that are US issuers or have US domestic concerns,[1] the US Department of Justice (DoJ) has provided further guidance to acquirers in the form of Opinion Procedure Releases no. 08-02 and 14-02. According to these releases, some of the key considerations for acquirers to mitigate ABC risk exposure include:

1. Were any 'red flags' pertaining to ABC identified during the pre-investment process? Any information obtained that would suggest a violation should be reported to the DoJ immediately after closing.[2]

2. In situations where insufficient time and inadequate access to information were available to complete an appropriate ABC due diligence pre-investment, the DoJ agreed to allow the acquirer to prepare an ABC due diligence work plan within 10 business days of the closing, and to have the due diligence completed within 180 days of the closing. This work plan would address, amongst other things, the use of agents and other third parties; commercial dealings with state-owned customers; any joint venture, teaming or consortium arrangements; customs and immigration matters; tax matters; and any government licences and permits.

   An ERM approach and road map should be undertaken to organise risk elements into high, medium and low risk, and these should be addressed appropriately in order of priority. It is imperative to include sufficient transaction testing in the due diligence phase to ensure the investment target management presents itself in a way that is consistent with what is shown in the books and records.

3. In any respect, PE firms should consider performing a gap analysis between their minimum standards for ABC and those of the portfolio entity. Policy gaps identified should be fixed quickly by implementing appropriate new policies, standards and thorough training shortly after the investment has been made.

[1] 'Issuers' refers to US and foreign public companies listed on stock exchanges in the US or which are required to file periodic reports with the U.S. Securities and Exchange Commission (SEC); and 'domestic concerns' include (a) US citizens, nationals and residents; and (b) US businesses and their officers, directors, employees, agents or stockholders acting on the domestic concern's behalf.

[2] This is the DoJ's view, and quality legal advice should be sought before contemplating such action.

Ongoing monitoring and exit considerations

An ERM approach for ABC is not a one-off event or something that is the responsibility of internal audit departments or risk teams. To succeed, a company's ABC standards must be applied and understood by all employees, enforced by all levels of management, and instituted across the company group.

Below are some monitoring suggestions and cultural considerations:

1. Continuous monitoring activities should be performed to evaluate the effectiveness of the ABC compliance programme. An effective way to do this is applying forensically designed data analytics, for example analysing employee travel and expense disbursements to identify outliers in terms of where and to whom payments are being made, as well as the purpose and amount of payments.

2. Subject matter professionals, either from the PE firm, the investment target or engaged externally, should carry out regular thematic audits to test, inter alia, whether new employees have received appropriate induction training, whether training programmes have reached all necessary officers/employees and in the appropriate medium/language, whether the established policies have been followed in practice, and how reported incidents were being dealt with.

3. Exit considerations (initial public offerings (IPOs), trade sales or secondary sales) should also be taken into account throughout the monitoring period. If the PE firm is contemplating an IPO for a portfolio entity, IPO readiness assessments, attracting the right IPO sponsor, and the general listing requirements may all be affected if the firm does not have strong ABC policies. Ultimately, if the entity had previously suffered material losses or reputational damage due to ABC breaches, potential acquirers could consider padding risk premiums when considering a target's valuation.

KPMG: Global Leadership in Financial Services

KPMG is a global network of professional firms providing Audit, Tax and Advisory services. We operate in 155 countries and have more than 162,000 people working in member firms around the world. The independent member firms of the KPMG network are affiliated with KPMG International Cooperative ("KPMG International"), a Swiss entity. Each KPMG firm is a legally distinct and separate entity and describes itself as such.

In 1992, KPMG became the first international accounting network to be granted a joint venture licence in mainland China. KPMG China was also the first among the Big Four in mainland China to convert from a joint venture to a special general partnership, as of 1 August 2012. Additionally, the Hong Kong office can trace its origins to 1945. This early commitment to the China market, together with an unwavering focus on quality, has been the foundation for accumulated industry experience, and is reflected in the Chinese member firm's appointment by some of China's most prestigious companies.

Today, KPMG China has around 9,000 professionals working in 16 offices: Beijing, Chengdu, Chongqing, Foshan, Fuzhou, Guangzhou, Hangzhou, Nanjing, Qingdao, Shanghai, Shenyang, Shenzhen, Tianjin, Xiamen, Hong Kong SAR and Macau SAR. With a single management structure across all these offices, KPMG China can deploy experienced professionals efficiently, wherever our client is located.

KPMG's Private Equity Practice

KPMG's Private Equity practice represents a strategic commitment to the sector and calls on its specialist teams in China and Hong Kong – across Advisory, Audit and Tax – to deliver the suitable approach to its clients. Engagements with the private equity sector, its investors or its portfolio companies encompass the full range of KPMG's services, including fund establishment and throughout the investment life cycle, such as portfolio asset management, fund and portfolio company audits and valuations, divestment, restructuring, and performance improvement.

Contact us

Internationally, KPMG member firms have established focused industry groups covering areas in which we have particular knowledge. Financial Services is one such area. In Hong Kong, we have a wide range of capabilities in our Financial Services group, servicing the private equity and investment management community. Feel free to contact the following individuals with your particular queries:

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Publication number: HK-PE15-0001

Publication date: October 2015