



# OUT OF THE SHADOWS

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Promoting Openness and Accountability  
in the Global Defence Industry

**Transparency International is the world's leading non-governmental anti-corruption organisation. With more than 100 chapters worldwide, Transparency International has extensive global expertise and understanding of corruption.**

**Transparency International Defence & Security works to reduce corruption in defence and security worldwide.**

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# CONTENTS

<b>Executive Summary</b> .....	<b>1</b>
<b>Corruption in the Global Arms Trade</b> .....	<b>3</b>
<b>The Evolution of Anti-Corruption Enforcement</b> .....	<b>5</b>
<b>The Future of Anti-Corruption in the Defence Sector</b> .....	<b>8</b>
<b>Leadership and Organisational Culture</b> .....	<b>9</b>
<b>Internal Controls</b> .....	<b>10</b>
<b>Support to Employees</b> .....	<b>11</b>
<b>Conflict of Interest</b> .....	<b>12</b>
<b>Customer Engagement</b> .....	<b>13</b>
<b>Supply Chain Management</b> .....	<b>14</b>
<b>Third Parties</b> .....	<b>15</b>
<b>Offsets</b> .....	<b>16</b>
<b>High Risk Markets</b> .....	<b>17</b>
<b>State-Owned Enterprises</b> .....	<b>18</b>

## ACRONYMS

<b>DOJ</b>	<b>Department of Justice (US)</b>
<b>DPA</b>	<b>Deferred Prosecution Agreement</b>
<b>EU</b>	<b>European Union</b>
<b>FCPA</b>	<b>Foreign Corrupt Practices Act</b>
<b>OECD</b>	<b>Organisation for Economic Co-operation and Development</b>
<b>SFO</b>	<b>Serious Fraud Office (UK)</b>
<b>UK</b>	<b>United Kingdom</b>
<b>UN</b>	<b>United Nations</b>
<b>US</b>	<b>United States</b>
<b>WTO</b>	<b>World Trade Organisation</b>

# EXECUTIVE SUMMARY

The global defence sector is both enormous and highly vulnerable to corruption. Over the last decade, both exporting governments and industry players have taken important steps to prevent corruption, but despite the many advances in law and compliance, corruption in the international arms trade persists.

More needs to be done to tackle this issue and the defence industry has a vital part to play. The next edition of the Defence Companies Anti-Corruption Index (DCI) will recognise those companies with the most proactive and ambitious approaches to tackling corruption. These companies will go beyond taking measures to protect themselves, and will be willing to make the kind of public commitments to high standards and disclosure of information which are critical for reducing corruption risks in the broadest sense.

Based on in-depth consultations with anti-corruption and defence experts, Transparency International have identified 10 key areas where increased disclosure and public commitments could reduce the opportunity for corruption in the defence industry.

## Key Recommendations

In addition to existing best practice anti-corruption measures, Transparency International recommends that the most progressive defence companies go beyond adequate procedures by meeting the following standards:

### 1. Leadership and Organisational Culture

- Publish a clear anti-bribery and corruption commitment with a zero tolerance approach, endorsed by the senior leadership;
- Ensure that responsibility for oversight of the anti-corruption programme lies with a member of the board;
- Ensure that the senior individual responsible for the anti-corruption programme has a direct reporting line to the board.
- Identify a senior individual who holds the ultimate responsibility for reporting criminal activity to law enforcement or regulators;
- Publish high-level results from internal investigations and disciplinary actions to deter wrongdoing, giving confidence to would-be whistleblowers, and demonstrating accountability in practice.

### 2. Internal Controls

- Design and implement an anti-bribery and corruption programme based on an assessment of the corruption risks the company is actually facing, with regular review at a senior level;
- Measure the effectiveness and implementation of their anti-bribery and corruption programmes through training, regular review, staff surveys or interactions with staff;
- Provide and deliver basic training to all staff and tailored training to employees working in high risk positions, to account for varying exposure to corruption risk;
- Ensure that incentive schemes are designed in a way that does not undermine the company's anti-corruption commitments;
- Actively support whistleblowers, through the implementation of robust mechanisms and consistent monitoring to ensure the effectiveness of and staff confidence in the system.

### 3. Support to Employees

## 4. Conflict of Interest

- Record all conflict of interest declarations pertaining to both employees and board members in a dedicated register;
- Follow an open and transparent procedure when employing a former public official, with effective controls to manage conflicts of interest;
- Regulate the services retained from serving public officials, by declaring any payments made for advisory services.

## 5. Customer Engagement

- Disclose full expenditure and details of all political contributions, charitable donations and sponsorships made by the company, including recipient name and amount paid;
- Publish the names of all lobbyists and lobbying expenditure;
- Disclose details of meetings with government officials when requested.

## 6. Supply Chain Management

- Conduct risk-based anti-bribery and corruption due diligence on all suppliers at least every two years, or when there is a significant change in the business relationship;
- Declare and publish the details of all suppliers with which the company has an active business relationship;
- Publish the high-level results from incident investigations and disciplinary actions against any suppliers used by the company.

## 7. Third Parties

- Ensure that remuneration and incentive structures are designed in a way that does not encourage dishonest or corrupt behaviour;
- Disclose the names and details of all agents employed by the company, including the nature of employment and beneficial ownership;
- Publish the high-level results from incident investigations and disciplinary actions against third parties, intermediaries or agents employed by the company.

## 8. Offsets

- Conduct enhanced due diligence on all aspects of an offset obligation, including offset beneficiaries and brokers;
- Disclose the names and details of agents, brokers or consultancy firms associated with a particular offset contract;
- Publish details of offset obligations, including the deliverable, contract value, number of offset credits received, and beneficiaries.

## 9. High Risk Markets

- Fully disclose all consolidated and non-consolidated holdings;
- Disclose the company's beneficial ownership and control structure;
- Publish a financial breakdown of defence sales by customer.

## 10. State-Owned Enterprises

- Disclose the structure of its shareholder voting rights, alongside details of its shareholder ownership;
- Follow an open and transparent process in the nomination and the appointment of its board members, as well as publishing details about the composition of the board;
- Ensure that its audit committee is composed of a majority of independent directors;
- Implement procedures to ensure that asset transactions are conducted according to market value.

## **CORRUPTION IN THE GLOBAL ARMS TRADE**

In 2016, the total sales of global arms and military services amounted to more than \$374.8 billion.<sup>1</sup> With global defence spending rising rapidly, competition is intense and the potential rewards – as well as the losses – are vast, making it a prime target for corrupt actors. A culture of secrecy, close relations with politics, and the sector's size and complexity all help to create an environment where corruption can thrive.

The effects of corruption as a driver of insecurity, conflict and human suffering are well-documented. It undermines the rule of law and democratic institutions, props up kleptocratic elites, acts as a rallying call for extremists, and diverts resources away from other areas such as infrastructure, healthcare and education. Corruption within the arms trade, however, is particularly pernicious. The close links between government and industry mean that when scandals do occur, senior politicians are often implicated, destroying citizens' broader trust in government. The sheer scale of military contracting means that corruption diverts much larger sums than it would in other sectors; the infamous South African Arms deal cost in the region of R30 billion and resulted in the purchase of a range of equipment that was barely used, while the population endured a spending freeze on healthcare at the height of the country's AIDS epidemic.<sup>2</sup> Finally, corruption deprives militaries of the equipment they need and is a key driver of weapons diversion to rogue actors.

Corruption is also bad for business. It distorts markets, raises costs and increases uncertainty. Ethical companies may shy away from certain markets due to the associated corruption risk, or simply because the business risks of operating in a rigged market are just too great. When allegations are levelled against a company, lengthy investigations divert resources and causes reputational damage – damaging shareholder trust, relationships with other businesses, recruitment, and workforce morale. Convictions or settlements may ultimately result in large fines, claims for damages and exclusion from markets.

Significant efforts have been made to reduce risk within the industry, yet it remains a regular feature of international arms deals. Coordination, shared learning, collective action and considerable developments in compliance have all had a role to play in advancing efforts by companies; and many companies have now satisfied themselves that they have 'adequate procedures' sufficient to avoid a prosecution or to minimise the risk of corruption taking place within the company itself. But for corruption in the arms trade to be tackled effectively, the industry cannot operate within this vacuum. Industry leaders must look beyond compliance and ask themselves whether 'adequate procedures' – ones that safeguard companies, but fail to prevent corruption – are really 'adequate' enough?

Greater transparency and disclosure is the key to meaningful oversight and reducing corruption risk. Transparency International have identified 10 key areas where further disclosure and public commitments could reduce the potential for corruption to take place. Companies may still choose to continue operating with lower levels of transparency and accountability than outlined in this report, but these choices are not cost-free and companies must then accept that they will face a higher risk of corruption in conducting business. The industry is not the only actor with the responsibility to deliver change, but nor should it underestimate its capacity to influence markets.

## What makes the defence sector especially vulnerable to corruption?

### Secrecy

Secrecy is a major facilitator of defence corruption. “National security” considerations may require some confidential spending on defence, but this amount varies widely. Some countries manage to keep this figure as low as two or three percent, while others classify the entire defence budget. The extent of independent oversight over classified budgets also varies widely – in the least transparent countries, even finance ministries may be unable to access information about the budget. Without oversight, spending cannot be debated or audited, enabling corrupt actors to operate with impunity. With one third of the world’s defence spending taking place in countries with no meaningful transparency over defence budgets, the risks in defence are widespread and affect the entire industry.<sup>3</sup>

### High value contracts

Contracts involving large-scale weapons platforms are often extremely lucrative and accompanied by a plethora of associated contracts such as whole lifecycle servicing and support. The rewards for winning these contracts are substantial, but so are the costs for losing. Even the biggest military spenders purchase warships and airframes infrequently, so the competition is intense and the pressures to incentivise customers to buy products they don’t really need or to break the rules during bidding, are high.

### Complexity of defence contracts

Even relatively straightforward defence contracts may take years to negotiate, potentially involving extensive supply chains, joint venture partnerships, agents, and offset obligations. The technical nature of defence equipment and weapons can also require companies to switch suppliers or adapt to local political developments throughout the construction and lifecycle of the product. The most developed anti-corruption laws extend company’s liability to their supply chains – and with defence contracting this often involves significant numbers of third parties, each requiring due diligence and supervision throughout the life of the contract. Meanwhile, the addition of offset contracting – which is essentially outlawed by the WTO and EU except in the defence sector – significantly increases these risks. These inherent characteristics of the arms trade add layers of complexity and opacity where corrupt behaviour has the potential to thrive.

### Political connections

Corruption in the defence industry is deeply political. Whether government decisions are motivated by the projection of power, foreign policy, or the desire to maintain a domestic industry, decision-making on defence purchases and sales regularly involves senior political figures. The risks arising from conflicts of interest, revolving door, campaign financing and lobbying are significant and exacerbated by the close and often opaque relationship between defence companies and government. It is perhaps no surprise that the top nine European arms manufacturers declared nearly €3.6 billion in defence lobbying expenditure in 2014.<sup>4</sup> The risks of politically involved corruption are present in every market, although markets at particularly high risk of political corruption are spending more on defence than ever before.

## THE EVOLUTION OF ANTI-CORRUPTION IN DEFENCE

The international consensus against corruption has grown enormously over recent decades. Multilateral institutions such as the United Nations, the Organisation for Economic Cooperation and Development (OECD), the European Union, and the International Organisation for Standardisation (ISO) have all played a role in the development of anti-corruption norms. In addition to the creation of international standards and multinational initiatives, these institutions have helped to promote a global understanding of bribery and corruption risks and how to combat them.

Anti-corruption regulations have also strengthened significantly. Legal evolutions such as the FCPA, UK Bribery Act and Sapin II have seen activities criminalised which were once simply 'the way business is done'. These laws are broad in reach and scope, capturing not just those engaged directly in corruption across jurisdictions, but including offences for those facilitating or even failing to prevent corrupt acts. Enforcement too has steadily risen, with international co-operation between prosecuting agencies on multi-jurisdictional investigations now increasingly common.

In consequence, the compliance industry has boomed – creating a whole sub-industry focused on mitigating corporate risk. Company compliance, for some, doubtlessly spurred on by the requirement to have 'adequate procedures', has evolved significantly; industry associations now have dedicated ethics committees and many companies participate in platforms such as the International Forum on Business Ethics (IFBEC) and the Defence Industry Initiative for Business Ethical Conduct (DII).<sup>5</sup> A combination of these factors has enabled ethics and compliance staff within major companies to access more resources and to receive more senior recognition for their work.

There is also some evidence that the culture of anti-corruption has changed. While some companies still raise concerns about publishing their ethics programmes, initiatives like IFBEC have led to increased sharing of learning and resources, with primes now taking a much more intrusive interest in the conduct and resilience of their supply chains and other third parties. Several companies have even taken more extreme steps to reducing their exposure to corruption by declining to operate in certain high-risk markets.

### Bad apples, or a rotten orchard?

Are most cases of defence industry corruption simply the result of a few 'rogue' employees? The evidence would suggest not. While it may be true that much has changed over the last two or three decades, systemic and cultural risks continue to plague the sector. Some of the most prominent cases have involved corrupt activity across multiple jurisdictions over several decades. The Rolls Royce allegations spanned 12 countries over 24 years, while Airbus is facing allegations of corruption in seven jurisdictions at the time of writing.<sup>6</sup> In 2010, a US judge presiding over the BAE Systems investigation stated that the company's conduct involved 'deception, duplicity and knowing violations of law, I think it's fair to say on an enormous scale'.<sup>7</sup> Historic cases across the sector indicate that where corruption has been uncovered, it tends to be widespread, authorised or encouraged at senior levels, and illustrative of an unethical corporate culture as a whole.

## A scourge of the past, or an ever-present danger?

Some argue that widespread corruption in the defence sector is a problem essentially consigned to the history books; that most of the leading exporters in OECD countries have now sharpened up their act, and that organisations like Transparency International should be focusing their attention on the emerging exporters, as well as Russia and China. They suggest the world has come a long way from the infamous Lockheed scandal that saw multi-million bribes paid to government officials across three continents throughout the 1950s and 1970s.<sup>8</sup> The evidence suggests otherwise. 2017 alone saw corruption allegations levelled and at least four investigations opened into Airbus;<sup>9</sup> while lengthy investigations were concluded and judicial decisions were reached against Rolls Royce, Korea Aerospace Industries, Dassault Aviation, Thales and Safran.<sup>10</sup>

Corruption within the defence sector remains stubbornly persistent. In recent years, many of the world's largest defence companies have faced significant allegations of corruption:

- In 2010, BAE Systems was ordered to pay £500,000, plus £250,000 in costs, to settle an SFO investigation into unexplained payments as part of a £28 million sale of a radar and air traffic control system to the Tanzanian government. The company was found guilty of failing to adhere to accounting standards and was instructed to make nearly £30 million in ex-gratia payments to Tanzania.<sup>11</sup>
- BAE Systems entered into another settlement with the US DoJ in 2010, relating to similar allegations of bribery in its dealings with the Czech, Hungarian and Saudi governments.<sup>12</sup> Under the settlement, BAE Systems pled guilty to one count of conspiring to defraud the US government, paid a \$400 million fine, and committed to strengthening its compliance programme moving forwards.
- In 2014, a UK subsidiary of AgustaWestland S.p.A (now under Leonardo) was fined €300,000 – while its parent company AgustaWestland was fined €80,000 – to settle an Italian investigation into allegations of bribery relating to the sale of 12 helicopters to the Indian military.<sup>13</sup> In addition, the court ordered the confiscation of €7.5 million in company profits.
- Rheinmetall Defence Electronics GmbH (RDE), a subsidiary of German arms manufacturer Rheinmetall, came under fire in 2014 for allegedly making 'unauthorised payments' to middlemen and officials as part of the sale of an air defence system to the Greek army. German prosecutors ordered the confiscation of €36.77 million in profits, along with a €300,000 fine.<sup>14</sup>
- In January 2017, Rolls Royce entered into record-breaking settlements in the US, UK and Brazil to settle numerous bribery and corruption allegations involving its concealment and use of middlemen over two decades.<sup>15</sup> The UK and US settlements involved Deferred Prosecution Agreements worth £497 million and \$170 million respectively, while a leniency agreement with Brazilian prosecutors amounted to almost £21 million.<sup>16</sup>
- Multinational aircraft manufacturer Airbus is currently facing investigations in multiple jurisdictions – including in the UK, US and France – relating to allegations of bribery and corruption in its use of third party consultants.<sup>17</sup> Airbus reached its first agreement in February 2018, when it agreed a €81.2 million settlement with German prosecutors pertaining to 2003 sale of Eurofighter aircraft to Austria;<sup>18</sup> but remains under investigation in the remaining jurisdictions.

## 7 Out of the Shadows: Promoting Openness and Accountability in the Global Defence Industry

Although some of these allegations relate to historic activity, there is also evidence of more recent transgressions and 2018 has already seen investigations launched into Chemring and Ultra Electronics.<sup>19</sup> The frequency of these investigations might point to better internal systems, or more effective reporting and law enforcement; nonetheless, corruption in the sector remains an ever-present danger.

To make matters worse, defence spending is rising in the markets at most risk of corruption within their defence institutions. Of the top ten defence importers 2013-2017, nine of them scored D, E or F in the Government Defence Anti-Corruption Index (GI). Defence companies globally will be keen to maximise the viability of these markets; and for companies with a British presence in particular, the pressures of Brexit may force them towards these markets at a rate they may be uncomfortable with when considering corruption risk. It may soon be much less financially tolerable for companies to decline to conduct business in corruption prone states, in the way that some have in the past.

### Top 10 Arms Importers 2013-2017: Government Defence Anti-Corruption Index (GI) Score<sup>20</sup>

Top 10 Defence Importers 2013-2017	Procurement Score (%)	Overall GI Score
1  India	54%	<b>D</b> High
2  Saudi Arabia	15%	<b>E</b> Very High
3  Egypt	8%	<b>F</b> Critical
4  UAE	21%	<b>E</b> Very High
5  China	29%	<b>E</b> Very High
6  Australia	68%	<b>B</b> Low
7  Algeria	10%	<b>F</b> Critical
8  Iraq	13%	<b>F</b> Critical
9  Pakistan	25%	<b>E</b> Very High
10  Indonesia	45%	<b>D</b> High

## Mitigating which risks?

The challenge for those engaged in the fight against corruption is that reducing corruption risk and reducing company risk are not always the same thing. In some cases, tighter regulation in exporting markets and stronger company compliance systems simply pushes risk elsewhere. Although the introduction of legislation such as the UK Bribery Act in 2010 marked an important step forwards, clauses like Section 7 may have inadvertently encouraged some companies to either outsource their risk to third parties or to make use of other vehicles for corrupt payments – such as offset contracting.<sup>21</sup> More generally, the focus of compliance tends to be on ensuring company procedures are adequate to avoid prosecution, rather than eliminating the potential for corruption in a broader sense. The question now is: how to move beyond company risk, to actually reduce the opportunities for corruption to take place.

# THE FUTURE OF ANTI-CORRUPTION IN THE DEFENCE SECTOR

Through an analysis of corruption cases and analysing best practice across the sector and other industries, Transparency International has identified 10 key areas where stronger controls and greater transparency within defence companies can reduce corruption risk:

- Leadership and Organisational Culture
- Internal Controls
- Support to Employees
- Conflict of Interest
- Customer Engagement
- Supply Chain Management
- Third Parties
- Offsets
- High Risk Markets
- State-Owned Enterprises

Recognising the limitations of compliance, the next edition of Transparency International's Defence Companies Anti-Corruption Index (DCI) will place a greater focus on implementation, oversight and publicly available information across these 10 areas. In particular, Transparency International is urging companies to make a significant contribution to tackling corruption through greater transparency, and therefore the next edition of the index will be researched solely on publicly available information.

The disclosure of information around beneficial ownership, contract deliverables, and details of any agents employed are among the essential tools that allow oversight bodies such as parliaments, external auditors, and ultimately the public, to hold governments to account. In the highest risk markets, where oversight and transparency is weakest, these disclosures are the only way the opportunities for corruption can be comprehensively addressed.

By putting this information in the public domain, companies are more likely to have seriously considered whether what they are saying is reflected in practice. Publicly available policies can be reviewed by suppliers, shareholders, enforcement agencies, employees and the public at large, and possess a legitimacy and permanence which greatly exceeds internal documents.

The industry has already come a long way in terms of what it is willing to make publicly available. But while commercial sensitivity and genuine national security concerns remain legitimate reasons for confidentiality, sector leaders have demonstrated that greater disclosure is possible.



## LEADERSHIP AND ORGANISATIONAL CULTURE

Company leadership comes under significant scrutiny in corruption cases, and with good reason. A 2014 OECD analysis of 427 foreign bribery cases over the previous 15 years discovered that at least half were carried out with the involvement of management.<sup>22</sup> In practice, recent corruption scandals continue to involve what the British judge who presided over the Rolls Royce DPA hearings referred to as ‘the controlling minds of the company’.<sup>23</sup> A recent example of corrupt leadership can be seen through the indictment of nine Korea Aerospace Industries executives – including the CEO – for offences ranging from bribery to price fixing and tax evasion, between 2013 and 2016.<sup>24</sup> Similarly, a former vice president of Patria Vehicles was fined and imprisoned in 2015, for bribing Croatian officials to secure a 2007 contract for armoured vehicles.<sup>25</sup>

While it might be convenient for companies to point to a few ‘rogue employees’, in these cases, responsibility – if not always culpability – lies at the top. Leadership does not just rest with the CEO; middle management bear the principal burden in terms of setting the tone and culture of the organisation for frontline staff. Effective and ethical supervision at every level of a company is crucial if staff are to have the confidence and support to make ethical decisions, even if it affects the company’s bottom line. International best practice currently stipulates that companies should adopt a comprehensive anti-bribery and corruption policy – prohibiting practices such as the bribery of foreign officials and facilitation payments – which applies and is accessible to all employees across the organisation.

In addition, the most progressive defence companies will strive to:

- Publish a clear anti-bribery and corruption commitment with a zero tolerance approach, endorsed by the senior leadership;
- Ensure that responsibility for oversight of the anti-corruption programme lies with a member of the board;
- Ensure that the senior individual responsible for the anti-corruption programme has a direct reporting line to the board.



# INTERNAL CONTROLS

There is no doubt that anti-bribery and compliance programmes play a vital role in safeguarding companies against corruption. They represent the backbone of an organisation's internal controls, and there are good reasons to suppose that compliance systems within the biggest defence companies are substantially better than a decade ago. In the 2015 edition of the Defence Companies Anti-Corruption Index, companies demonstrated the most improvement in the area of 'policies', with 56 companies increasing their score by at least 10 percent since 2012.<sup>26</sup> Yet all the companies recently embroiled in corruption scandals had anti-bribery and compliance programme in place, but still failed to stop corruption – why was this?

One explanation is a reliance on 'paper only' compliance programmes that are never truly implemented, or 'one size fits all' systems that are not properly tailored to the company's operations. Embedding anti-corruption ethics into the culture of an organisation and integrating compliance into the business model is essential in both practice and law. Enforcement agencies and prosecutors have made it clear that anti-bribery programmes which exist only paper will not be sufficient to avoid prosecution.

Companies operating in high risk markets need to apply additional controls to mitigate risk. Responsible companies will periodically assure themselves that programmes are still fit for purpose. And when internal controls fail to prevent corruption, but succeed in identifying it, the information needs to be managed and monitored by suitably qualified staff. The ultimate test of whether a company is living up to its ethical standards will be whether it chooses to self-report incidents of wrongdoing to the relevant authorities.

In addition, the most progressive defence companies will strive to:

- Design and implement an anti-bribery and corruption programme based on an assessment of the corruption risks the company is actually facing, with regular review at a senior level;
- Measure the effectiveness and implementation of their anti-bribery and corruption programmes through training, regular review, staff surveys or interactions with staff;
- Identify a senior individual who holds the ultimate responsibility for reporting criminal activity to law enforcement or regulators;
- Publish high-level results from internal investigations and disciplinary actions to deter wrongdoing, giving confidence to would-be whistleblowers, and demonstrating accountability in practice.

## SUPPORT TO EMPLOYEES

Robust internal controls don't exist in isolation. Controls also need to be accessible and tailored to all employees, across all divisions and areas of operation. Training forms a central part of this support system promoting an understanding of bribery and improper business conduct in order to develop employees' capacity to identify, avoid and resist corrupt approaches. Yet only 32 percent of companies surveyed in the 2015 edition of the Defence Companies Anti-Corruption Index showed evidence of an explicit anti-corruption training module.<sup>27</sup> Although this represented a substantial improvement from 16 percent in 2012, these figures should be much higher.<sup>28</sup>

Training alone is insufficient. Several of the most recent investigations into defence corruption are a result of reports from whistleblowers; yet in many cases, employees may be reluctant to do the right thing for fear of retribution. The ongoing allegations against Airbus subsidiary GPT Special Project Management provide a stark illustration of this risk. The company's financial comptroller was allegedly removed from his post after raising concerns over £11.5 million worth of unexplained payments that he was asked to authorise in 2007, as part of the company's dealings with the Saudi National Guard.<sup>29</sup> A second senior representative was allegedly threatened with dismissal and criminal prosecution after confronting the company's management with similar concerns in 2010.<sup>30</sup>

Defence companies should consider whether they are really doing enough to support employees who refuse to behave unethically. International best practice states that companies should adopt an explicit policy of non-retaliation against whistleblowers in all circumstances, as well as establishing and monitor the accessibility of whistleblowing channels.

In addition, the most progressive defence companies will strive to:

- Provide and deliver basic training to all staff and tailored training to employees working in high risk positions, to account for varying exposure to corruption risk;
- Ensure that incentive schemes are designed in a way that does not undermine the company's anti-corruption commitments;
- Actively support whistleblowers, through the implementation of robust mechanisms and consistent monitoring to ensure the effectiveness of and staff confidence in the system.



## CONFLICT OF INTEREST

Conflicts of interest are a major risk in defence, where a small number of companies compete for high value, opaque and relatively infrequent contracts with a small number of customers. Conflicts frequently occur through personal connections, as evidenced in Israel's proposed purchase of three submarines and four naval vessels from German company ThyssenKrupp in 2016 – a deal worth approximately €1.5 billion.<sup>31</sup> David Shimron – Prime Minister Benjamin Netanyahu's second cousin and personal lawyer – allegedly leveraged his relationship with the leader to help push the deal through on behalf of ThyssenKrupp, despite opposition from Israeli defence ministers.<sup>32</sup> Although both Netanyahu and Shimron have denied the allegations of misconduct, the involvement of the prime minister's relative and personal lawyer in the defence deal raises clear conflict of interest risks at the highest levels of government.

The movement of employees between the public and private sector – or the “revolving door” – also presents significant risk. A 2010 investigation by the Boston Globe emphasised the pervasiveness of the revolving door in the defence industry, noting that 80% of all retiring three and four star generals had undertaken employment with US arms manufacturers between 2004 and 2008.<sup>33</sup> Similarly, UK Ministry of Defence officials and associated military officers have accepted more than 3,500 jobs with defence companies and arms manufacturers since 1996.<sup>34</sup>

At a minimum, these risks can be controlled through comprehensive policies and procedures to identify and manage actual, potential and perceived conflicts of interest. A designated body should hold responsibility for overseeing such declarations, together with deciding how such conflicts can be mitigated. The next step is to institute clear policies covering the movement of employees between the public and private sector, to guard against the underlying dangers of the ‘revolving door’.

In addition, the most progressive defence companies will strive to:

- Record all conflict of interest declarations pertaining to both employees and board members in a dedicated register;
- Follow an open and transparent procedure when employing a former public official, with effective controls to manage conflicts of interest;
- Regulate the services retained from serving public officials, by declaring any payments made for advisory services.



## CUSTOMER ENGAGEMENT

Closed-door meetings between procurement officials and defence companies can be legitimate and sometimes necessary, but they also create opportunities for bribery, influence-peddling and the development of relationships which could lead to potential or actual conflicts of interest.

Major arms manufacturers often seek to exert influence on national governments and international organisations through strategic lobbying, to increase their likelihood of being selected for a specific high value tender or to influence policy making. The amount that companies spent to achieve this is massive: three of the Pentagon's largest defence contractors – Lockheed Martin, Boeing and Northrop Grumman – shelled out a combined \$42 million on lobbying in 2017 alone.<sup>35</sup> And in Europe, nine out of the ten largest defence companies maintain an ongoing lobby presence in Brussels, with accredited lobbyists who can access the European Parliament.<sup>36</sup>

But lobbying is not the only form of inappropriately influencing the customer. Charitable donations, political contributions, gifts and hospitality can all be used as vehicles for bribery and corruption if not closely monitored or regulated. The case against US defence contractor FLIR Systems provides a clear illustration of these risks: in 2014 the company was fined \$9.5 million for providing lavish gifts, entertainment and travel to government officials from Saudi Arabia who were involved in the decisions to purchase the company's products and services.<sup>37</sup> FLIR Systems reportedly gained more than \$7 million worth of profits over three years from sales influenced by these inappropriate gifts and expenses.

The risks associated with inappropriate customer engagement are best mitigated through robust procedures and increased public disclosure. International best practice already calls for companies to adopt clear policies to regulate political contributions, charitable donations, sponsorships; gifts, hospitality and expenses; and lobbying, to protect against the exertion of undue influence on policymakers.

In addition, the most progressive defence companies will strive to:

- Disclose full expenditure and details of all political contributions, charitable donations and sponsorships made by the company, including recipient name and amount paid;
- Publish the names of all lobbyists and lobbying expenditure;
- Disclose details of meetings with government officials when requested.



## SUPPLY CHAIN MANAGEMENT

Complex supply chains, involving multiple entities and operating across different geographies and sectors, are a regular feature in the defence industry. Supply chain corruption can manifest in both supplier selection, as well as contract delivery. In some cases, this may mean the direct involvement of company employees – just as Ronco Consulting Corporation found when one of its managers accepted bribes paid by Mondial Defence Systems to secure contracts in Afghanistan and Iraq.<sup>38</sup>

Governments are also increasingly intervening in supply chains, requiring the use of domestic suppliers or single-source tenders, in order to create jobs, retain investment, and enhance their domestic defence industry. And in many cases, this market intervention takes place in regions of the world where the culture of corporate ethics is poor and regulation is weak. As tiers of suppliers become more remote from the principal contractor, the opportunities for corruption become greater with less clarity over everything from conflicts of interest to beneficial ownership and financial transparency.

Although greater scrutiny is already being placed on tackling supply chain issues such as modern slavery or environmental sustainability, best practice on corruption is relatively undeveloped.<sup>39</sup> Research by The Economist Intelligence Unit even indicates that 30 percent of companies scaled back their focus on developing ethical supply chains between 2013 and 2017.<sup>40</sup> This is surprising, given that a 2017 assessment found that nearly one third of surveyed executives identified suppliers as key perpetrators of fraud, and 51 percent said they were concerned that their organisation may be vulnerable to supplier fraud.<sup>41</sup>

The most responsible companies will assure themselves of every supplier's beneficial ownership and ensure that each company's anti-bribery and corruption policies are at minimum comparable to their own – assisting them in improving if needs be. Best practice means including anti-bribery and corruption clauses in all contracts with significant external suppliers, with specific audit and termination rights.

In addition, the most progressive defence companies will strive to:

- Conduct risk-based anti-bribery and corruption due diligence on all suppliers at least every two years, or when there is a significant change in the business relationship;
- Declare and publish the details of all suppliers with which the company has an active business relationship;
- Publish the high-level results from incident investigations and disciplinary actions against any suppliers used by the company.

## THIRD PARTIES

The use of third parties, intermediaries, and agents in defence procurement is widely recognised as one of the most significant and pervasive bribery and corruption risks in defence.<sup>42</sup> In this context, third parties can mean a whole range of businesses and individuals associated in the competition, negotiation or execution of a contract, including any agents, distributors, advisors, lobbyists, brokers, consultants and joint venture partners.

The use of third parties can make a valuable contribution for any organisation. But agents pose a unique corruption threat as they may be authorised to act on behalf of the company, often with a high level of discretion and minimal oversight.<sup>43</sup> If not appropriately incentivised and overseen they can facilitate large-scale bribery, as in a 2011 investigation which revealed German arms company Ferrostaal had allegedly made €1.18 billion in 'questionable payments' to agents in a number of countries, including Portugal, Greece, South Korea and Indonesia.<sup>44</sup> In total, 90 percent of FCPA cases brought in 2013 involved the use of an agent, while an OECD study of 427 cases between 1999 and 2014 found that three out of four foreign bribery cases involved intermediaries, with the majority of these involving the payment of bribes to obtain public procurement contracts.<sup>45</sup>

Compliance professionals now consistently identify joint ventures as an area of significant third party risk. The nature of joint ventures in the defence sector mean that companies can be minority partners working in unfamiliar or new markets, and may be required to engage with state-owned enterprises where the state may have a controlling interest. Anti-corruption measures must play a central role in negotiations and on an ongoing basis if they are to be effective.

As such, companies that choose to use third parties despite the risks must implement stringent processes to manage them. International best practice emphasises procedures to conduct enhanced due diligence on all business associates. At minimum, this should include checks to determine whether the third party (including agents, intermediaries and joint ventures) has any actual or potential conflicts of interest, past involvement in dishonest business practice, or unclear beneficial ownership. Companies should also include formal anti-bribery and corruption clauses in all contracts with third parties, providing the company with audit and termination rights.

In addition, the most progressive defence companies will strive to:

- Ensure that remuneration and incentive structures for third parties are designed in a way that does not encourage dishonest or corrupt behaviour;
- Disclose the names and details of all agents employed by the company, including the nature of employment and beneficial ownership;
- Publish the high-level results from incident investigations and disciplinary actions against third parties, intermediaries or agents employed by the company.



Offsets represent one of the most opaque practices in the defence industry.<sup>46</sup> Although offsets can fulfil an entirely legitimate purpose, the frequent lack of transparency and oversight makes them one of the most profound areas of corruption risk for the sector. In the EU, offsets are illegal in all sectors except for defence; yet a 2015 study indicates that at least 80 countries worldwide require offset arrangements when purchasing defence equipment, systems or services.<sup>47</sup>

On a case-by-case basis, there may be an argument for direct military offsets to remain secret. This however is rarely ever justifiable for indirect offsets, yet it is normal for very little information to be disclosed. Even where offsets are broadly disclosed to the public, there is little economic evidence to suggest that such agreements benefit the purchasing country; offset obligations as part of the 1999 South African Arms Deal were expected to generate 65,000 new jobs and revenue in excess of R111 billion but, in practice, the cost to the state almost doubled within the first two years.<sup>48</sup> Parallel allegations involving close links with politicians and influential families have plagued this deal over the last decade.

The opacity of offset contracting is exacerbated by its complexity, where credits and multipliers can distort the market value of the transaction. Under the South African Arms Deal, for example, reports indicate that German company Ferrostaal received €3.1 billion in offset credits on an initial investment of just €69 million.<sup>49</sup> Moreover, the lack of scrutiny over offset contracts creates the opportunity for bribery: a 2004 submarine deal saw executives from a group of German defence firms stand accused of paying Portuguese officials '€1 million to disguise old investments as new ones...to fulfil the offset obligations'.<sup>50</sup>

Although offset obligations are often determined by the purchasing government, there are several steps that companies can take to increase transparency and, therefore, minimise the associated corruption risks. At a minimum, companies should recognise the corruption risks associated with offset contracting and explicitly address these risks through policies and procedures.

In addition, the most progressive defence companies will strive to:

- Conduct enhanced due diligence on all aspects of an offset obligation, including offset beneficiaries and brokers;
- Disclose the names and details of agents, brokers or consultancy firms associated with a particular offset contract;
- Publish details of offset obligations, including the deliverable, contract value, number of offset credits received, and beneficiaries.



## HIGH RISK MARKETS

Corruption risks vary across markets. As multinational companies develop and expand into new and emerging markets, the ability of businesses to identify and impose controls on the relevant corruption risks will continue to be a crucial part of best practice.

Between 2013 and 2017, nine of the top ten global importers were rated as being at high or very high risk of defence sector corruption. Between 2007 and 2017, 73 percent of UK and 48 percent of US arms exports were destined for countries identified as high-risk markets for defence corruption.<sup>51</sup> In almost all cases, the level of risk in a particular market is determined by the depth of transparency and oversight of both the government and the defence industry. Companies operating in countries with very low transparency and oversight inevitably face a much higher risk of corruption. Therefore, the more information that companies proactively put into the public domain, the easier it is for government oversight bodies to function effectively.

There are, of course, practical limitations on transparency in the defence industry, due to commercial sensitivity and national security. But there is such a wide variance in how these limitations are applied, and often these concerns are overstated. Indeed, it is often the places that are most at risk of internal conflict that insist on maintaining high levels of secret spending. Governments and companies alike have their role to play, and several companies are already in nudging the market towards more transparency. In 2016, one of the world's most controversial companies, Heckler and Koch, announced they would no longer export to countries which are corrupt, undemocratic, or not in some way affiliated to NATO.<sup>52</sup>

Overall, current best practice for companies operating in high risk markets tends to rely on doing “more of the same”. Measures such as enhanced due diligence and interrogation of beneficial ownership will help. But in countries where there the military effectively runs the government, and the finance ministry may have no oversight of defence procurement, greater openness is essential to mitigate the risk of corruption.

In addition, the most progressive defence companies will strive to:

- Fully disclose all consolidated and non-consolidated holdings;
- Disclose the company's beneficial ownership and control structure;
- Publish a financial breakdown of defence sales by customer.



## STATE-OWNED ENTERPRISES

State-owned enterprises (SOEs) may not pose an inherent corruption risk. But such companies can encounter particular vulnerabilities that privately-owned companies may not. An intrinsically close relationship with the ownership entity – in this case, the state – can leave SOEs vulnerable to significant political interference. Even where companies are only partially state-owned, the potential for influence and intervention from state actors is very high. The governance structure of SOEs also creates the opportunity for anti-competitive behaviour.

The evidence suggests that this results in much higher corruption risks. A 2016 study conducted by the OECD found that employees of SOEs represented almost one third of all individuals who promised, offered or paid bribes in the 427 incidents examined.<sup>53</sup> The 2015 edition of the Defence Companies Anti-Corruption Index reinforced these findings, ranking 86 percent of the fully state-owned companies in the bottom three bands (D, E and F).<sup>54</sup> Adding to this, instances of corruption within SOEs can have devastating consequences on the national government, economy and general population; it can impact citizens' trust in state institutions in a way that private company corruption scandals may not.<sup>55</sup>

In addition to the guidance for private companies already discussed, the most progressive state-owned defence companies should strive to:

- Disclose the structure of its shareholder voting rights, alongside details of its shareholder ownership;
- Follow an open and transparent process in the nomination and the appointment of its board members, as well as publishing details about the composition of the board;
- Ensure that its audit committee is composed of a majority of independent directors;
- Implement procedures to ensure that asset transactions are conducted according to market value.

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## 21 Out of the Shadows: Promoting Openness and Accountability in the Global Defence Industry

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