White paper

Really getting to know your third parties

Trade is no longer purely transactional, and it's essential to understand exactly who your third parties are. This whitepaper discusses how to protect your business reputation in an increasingly complex world of third-party corporate compliance

BUREAU VAN DIJK

A Moody's Analytics Company

Contents

Introduction:

the growing significance of third parties

"Third party" has a variety of narrow definitions in business and law, some implying a layer of separation or distance between two parties.

But in the expanding world of company due diligence, the term has become much broader, extending to any person or entity outside your organisation with whom you have any sort of contractual relationship; and it implies quite the opposite: inextricable closeness, and a closeness that could come under scrutiny either by regulators or by the public – whether the press, social media or your potential market.

These third parties could be your customers, suppliers, agents and distributors, or joint-venture business partners. Indeed, "business partner" could be used as a near-synonym for "third party" in the context of ongoing and significant relationships.

Gone are the days when trade was purely transactional.

Delivering private company information and technical solutions used in risk analysis for a quarter of a century, we at Bureau van Dijk can make this assertion with a high degree of confidence.

Ted Datta, director of governance, risk and compliance solutions at our London offices, suggests that: "third-party relationships are being – and should be – treated as partnerships." He adds:

Ted Datta,
director of governance,
risk and compliance at
Bureau van Dijk in the UK

"Businesses can no longer turn a blind eye when inadvertently and indirectly 'buying diamonds from warlords'."

While this is an extreme example, it illustrates a crucial point: that you have a responsibility for who you do business with. Your third parties' wrongdoings are, by extension, yours in the eyes of anyone taking a view on your business and its conduct.

And the cost of a damaged reputation can be massive; according to a widely cited study by the World Economic Forum in 2012, more than 25% of a company's market value is directly attributable to its reputation, a terrifying statistic when you consider Warren Buffett's plausible claim that "it takes 20 years to build a reputation and five minutes to ruin it".

This is before you even consider PEPs and Sanctions, and anti-money laundering regulations from the likes of the Office of Foreign Assets Control (OFAC) in the US and similar bodies in the EU. Officially applying to everyone, these currently most directly affect the banking sector and other heavily regulated professions day-to-day. But they're contributing to this climate of heightened compliance and have a clear knock-on effect on anyone banks deal with and lend money to; to renegotiate its banking agreement, one of Bureau van Dijk's clients, a large manufacturer and retailer, had to demonstrate to a very well-known international bank that it had started the ongoing process of performing enhanced and rigorous supplier due diligence, in just one of many recent examples of changing practice.

Even the so-called “unregulated” corporations are bound by related laws on both sides of the Atlantic, such as those on anti-bribery, money laundering and corruption; and, in the informed opinion of Bill Hauserman, senior director of compliance at Bureau van Dijk in the US, the clock is ticking for corporates. “It’s a question of when, not if, these regulations will apply more widely,” he says. “The tide is flowing, so corporations need to prepare.”

So how do you find out what your business partners have been up to? We’ll get to that.

But more than half the battle is establishing who your business partners actually are, because sanctioned persons and entities can hide behind cloudy parent companies with complicated ownership structures, something that provides no responsibility buffer to the unwitting.

Let’s take a quick look at company ownership and specifically *beneficial* ownership...

Beneficial ownership:
a pivotal component of the vetting process

Companies range from small one-man-bands, which are often wholly owned and run by single individuals, to huge listed corporations, owned by thousands of shareholders, each with only a tiny stake in the business. This is familiar territory.

But what of those in the middle, where the proportionate stakes in ownership and – crucially – control are less clear? These companies are of most concern to us, in both senses of the word. Gigantic but unlisted corporations with a small number of shareholders are also of interest, as are consortia who own corporate shares in listed corporations. But we can consider these alongside this “muddled middle”.

To manage our reputation risk, we ultimately need to establish who our third parties’ “beneficial owners” are. These owners and controllers are the focus of our discussion throughout this paper. But what does this term actually mean?

Definition

According to the Financial Action Task Force (FATF), an independent inter-governmental body that develops and promotes policies to protect the global financial system against money laundering and terrorist financing, beneficial owners are the natural person or persons who ultimately own or *control* (our italics) a legal entity and/or the natural person on whose behalf a transaction is being conducted. They also include people who exercise ultimate effective control over a legal person or arrangement.

The terms “ultimately owns or controls” and “ultimate effective control” refer to situations in which ownership or control is exercised through a chain of ownership or by means of control other than direct control. The FATF Recommendations are recognised as the global anti-money laundering (AML) and counter-terrorist financing (CFT) standard.

Different percentage thresholds exist in different jurisdictions (and Bureau van Dijk’s sliding-scale models reflect these) but generally if they’re in double figures, you should take note.

In a nutshell, if you’ve identified an actual person and they own and/or control a significant portion of a business, then they’re likely to be a beneficial owner and you need to know whether they’re on any blacklist.

Indirect ownership

Things get complicated when indirect ownership enters the equation – something that's very common in all but the smallest businesses.

Some indirect ownership is theoretically straightforward. If Person A owns, say, 75% of Company A, which itself owns 40% of Company B, Person A therefore indirectly owns and controls 30% of Company B (plus any other stakes through other routes). But the complication is that these relationships can often be very hard to identify (more later).

Incorporate circular ownership into the cocktail and analyses can grind to a halt without the right tools.

Circular ownership

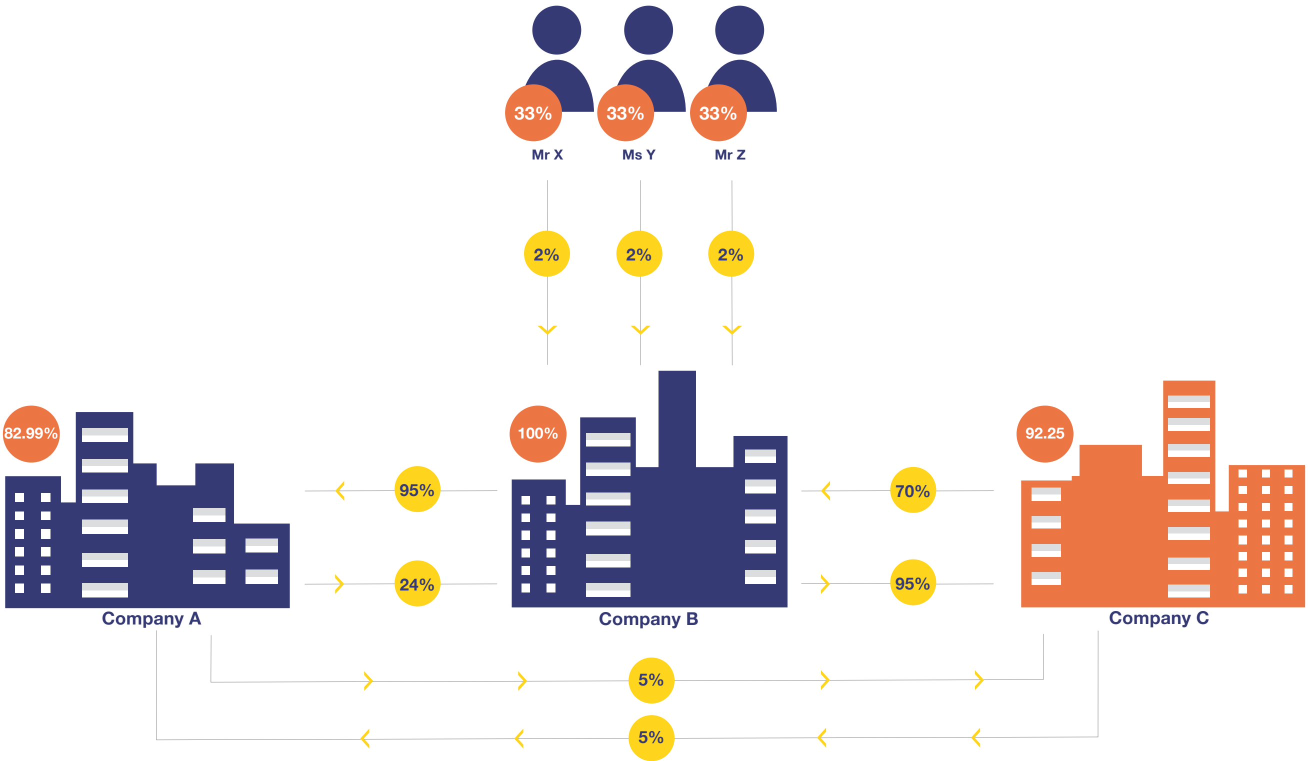
Circular ownership, a special but not uncommon type of indirect ownership, gets really messy.

The reasons why groups of companies set them up vary; sometimes it's legitimate tax avoidance or it's simply evolved haphazardly over the years but it can be to disguise real control. If you suspect that's the case, alarm bells should ring. We should also note that in some countries, such as Italy and Norway, it's illegal for companies to have more than a 10% stake in themselves.

In them*selves*? Yes, and that's part of the crux of this peculiar form of ownership. Groups of companies can set up a sort of loop in which they each own varying portions of other companies in the loop, sometimes resulting in their owning a portion of themselves.

We won't delve too deeply into the sums but, in essence, in such schemes, if you tally the ownership percentages *into* each company, most (but never all) companies in the loop will derive 100% of their ownership entirely from other companies (not individuals) in the loop. Where they don't, the shortfall represents the percentage that their books *will* say are owned by actual people. These quoted percentages will be lower than what these people actually own and control if they're the only people associated with the loop.

In the example below, only three individuals are attached to this group of companies. With Company C in orange as the "focus", this view indicates that they each own just 2% of another company in the group, Company B. This company is the only one in the group that isn't 100% owned by other companies; 94% of it is owned by other companies, hence 6% remaining, which is split three ways between three individuals. So in reality and by most measures, they each own and control 33.33% of the family of businesses.



Understanding the implications for vetting

If you trust the data and mechanisms behind the tools that identify both this circularity and the implied beneficial ownership that results from it, it's sufficient to be aware of it and understand the implications rather than grasp all of the calculations that are applied behind the scenes.

That's an overview of the theory. Let's look at the practice.

Beneficial ownership is discussed in more depth in the Bureau van Dijk whitepaper, Getting to grips with the challenge of beneficial ownership.

Plugging your third-party knowledge gaps

At Bureau van Dijk we've been gathering and validating private company information for more than 25 years, so we've racked up a lot of client dialogue. And a common theme of our conversations, particularly in recent years, is corporations' nagging doubts that the integrity of some of their third-party relationships are based on a false sense of security.

People's knowledge often extends only as far as the readily available information on the more transparent companies: the very ones we probably need worry least about. After all, as Hauserman says:

"the standard is 'know with whom you're doing business'; it doesn't say 'know with whom every fourth person you're doing business'".


Bill Hauserman, senior director of compliance at Bureau van Dijk in the US

Discussing what we could describe as the "underserved corporate market", Hauserman identifies four gaps in partner due diligence. Also covered in this short video, they are summarised below.

Gap 1: Decisions around "perceived risk" and "unknown risk"

According to Hauserman, not all business partners are getting covered in companies' due diligence programmes, primarily because they can't afford it.

"What's happening," he says, "is that they're taking a minority of business partners and, through a risk assessment, suggesting that there's a 'perceived risk' that what they do and where they do it, and the value of their engagement, is what drives potential bribery risk. And that's [just] a perception" He adds that, worse, "the majority typically are not being included in the programmes," leading to a whole range of unknown risk, which can have a far worse long-term impact.

The answer to this problem is to use tools that contain reliable and extensive data but are tailored to bring the companies, parent companies and beneficial owners that deserve close attention to the surface.

Gap 2: Poor "core" data on business partners

"Core" data is often very poor, says Hauserman. Because of out-of-date databases, some companies simply don't know the registered names of their business partners or the countries in which they're registered.

Says Hauserman: "The problem is that the due diligence activities require good registered names in order to be able to find these companies in commercial databases. So that's a major second problem. Screening conducted with inaccurate registered names is by definition flawed and continuous monitoring of flawed names can be useless."

Simply identifying the existence of a company and validating it relies on accurate and regularly updated data.

Gap 3: Flawed questionnaires for entity data collection

"Questionnaires are suspect by definition," says Hauserman, who cites companies' over-reliance on them. He adds: "At a minimum [questionnaires] need extensive validation. [But] what's better is to be able to eliminate [them] as the source of due diligence information."

This hugely increases accuracy, Hauserman says, with company financials providing an example of common discrepancies between reality and the answers given on questionnaires.

You can fill the gap left by flawed questionnaires with other processes that a) lead you to identify the beneficial owners, as well as other hidden-away companies in the same group, and b) allow these names to be checked against PEPs (politically exposed persons) and Sanctions lists and the like.

Gap 4: Lack of ownership transparency

Ownership transparency is demanded by the regulators, says Hauserman. Ownership structures have become "very much a part of the regulators' expectation for being part of due diligence," he adds, and a proper understanding of them will help slow global corruption.

"Content is king in due diligence," says Hauserman. This is where Bureau van Dijk's layers of information bring huge added value to risk management. With consistency across different geographies, the company is "solving the due diligence dilemma in a very straightforward way," he says.

This also applies to the broader areas of corporate compliance, as discussed elsewhere. And while content is king, the way it's structured is its consort.

These are the gaps of *identification*; so who you are directly or indirectly dealing with. What about the knowledge gaps surrounding these third parties' PEPs and Sanctions status, adverse media positions and other potential areas of concern?

Concerning activities

Individuals, companies and countries can all make it on to the various sanctions lists that a number of national and international bodies maintain.

If you've accurately identified the country in which a company is registered, it should be clear whether you can legitimately do business with it. This applies to companies you have a direct relationship with, as well as any higher up the same branch of the ownership tree.

Companies themselves are a little more difficult but, again, accurately identifying and validating them is the hardest job; checking them against sanctions lists is straightforward, completing a process that we might call "entity name up- and downstream due diligence".

Individuals are more difficult still, depending on how common their names are.

But the right tools provide enough structured information to make positive identifications based on the balance of probability and your risk appetite.

Risk appetite is a big factor with PEPs. Someone purely being politically exposed is no indication at all of whether they're corrupt. But it *does* indicate an increased risk in their being approached by other people trying to corrupt them. Whether that's a risk you want to take is your call. But it's important to be aware of it.

The lists that these names can be checked against are covered in the technology section later in this document.

Cases in point: examples from the media

There are a great many examples of third-party corporate compliance process gaps that have fallen under the media glare. We won't dwell on them but to illustrate our point, we'd highlight these recent stories regarding:

- US-registered Agilent Technologies, which disclosed that employees in China working with third-party intermediaries may have violated the company's business conduct policy and the FCPA;

- A report discussing the widening list of professions under regulatory scrutiny, for which we can imagine the media fallout for contravention and knock-on effects for other sectors; and

- A bribery-related court ruling in China for GlaxoSmithKline, which as well as costing the company over $350 million in fines, will have damaged its reputation and therefore future business, and indicates a possible failure of third-party (and internal) due diligence from GSK's compliance team.

Gathering corporate ownership data:

our methodology

In the Bureau van Dijk white paper, **Untangling the world of private company information** (http://bit.ly/20XzzcM), we discuss in depth the culture and practice behind gathering financial data from companies all over the world.

This data contributes to part of the due diligence picture. But what of ownership data of your third parties, arguably the most important area when considering your reputation risk?

At Bureau van Dijk we have a large team of ownership data specialists who collate and structure the ownership-related information that our various information providers around the world collect as part of their research into company financials.

The team also sources information directly themselves from a variety of outlets, such as national stock exchanges, company websites, annual reports and other officially filed documents, as well as by directly contacting the companies in question.

As there are generally a number of sources for the same information, when discrepancies arise, our researchers see these as their prompt to undertake further investigative work to determine true ownership, applying a variety of rigorous internal controls to the data.

To date 45 million active and navigable ownership links have been established in Orbis, our global database of close to 200 million private companies (plus all listed companies). This is in addition to its huge set of historical ownership links.

We also offer an alerting service for changes in ownership.

Bureau van Dijk's mergers and acquisitions division, which is responsible for the contents of the M&A database, Zephyr, also gathers ownership information as part of its day-to-day activities, using sources similar to the above. This information has huge relevance for a compliance audience, so Zephyr is used as another source for general ownership information across Bureau van Dijk's collection of databases and platforms.

Different thresholds of disclosure are applied to different types of deals (whether it's listed companies buying listed or private companies or private companies buying private companies), so nobody can guarantee a 100% complete set of data. But we do what we can to highlight ownership, in many cases going below 1%.

These combined ventures maximise your chance of finding a traceable path through to the true beneficial owners of your third parties.

But of course data needs to be interrogated and interpreted, which brings us on to ever-improving technology for reputation risk management.

How technology has emerged to address your bussiness challenges

Bureau van Dijk is not alone in providing databases of company information, such as Orbis. But we've been doing it for a very long time; we work with over 140 reputable information providers around the world; and we go to tireless efforts to structure the data in ways that standardise it and make it easy to digest for its various intended audience.

Three things come to mind when considering the best technology to help with corporate compliance.

- The first is that, where possible, people want to conduct their research on one platform.

- The second is that – particularly in this sphere – you want to be able to see the bigger picture, literally, when it comes to complicated ownership structures.

- And finally, given the sheer volume and increasing complexity of company checks, busy users hanker for process-driven tools and decision models.

These weren't just hunches; from analysing usage metrics and speaking to numerous customers, we recorded a growing trend in certain Orbis users shifting their focus away from viewing company reports and ownership information in isolation, towards following set processes to arrive at predefined decisions influenced by their own data and internal risk parameters.

We responded to these drivers by building Compliance Catalyst, a platform that blends data from Orbis with clients' own data from their portfolio of third parties and potential third parties, making it a single platform for their due diligence research, and one that streamlines and automates the on-boarding processes that had started to develop organically with Orbis.

As well as incorporating its company reports, Compliance Catalyst displays Orbis's ownership structures. Also available in a number of formats on several of our other platforms, these dynamic visualisation tools literally give you as full an ownership picture as the available data allows, and your threshold for beneficial ownership percentage can be shifted according to local laws – it's 25% in the EU, for example, but when considering your reputation, taking a lower figure can be sensible, and on Compliance Catalyst, you can go as low as 5%. You can also plug in parameters from your in-house decision model.

On what to do with the names, entities and countries that your research identifies, you simply check them against the WorldCompliance database, which is plumbed into Compliance Catalyst. WorldCompliance data is also tagged to entities across our product range, so it's available in different views.

All of these processes can be tailored to your own risk processes, appetite and workflow, ultimately aiding your yes/no decision on whether to work with someone.

What it all means for your business and third-party relationships

An occasional look at the business section of any serious newspaper is all it takes to sense that times have changed in the drive against corporate corruption.

It's gone global. And, as a recent KPMG report points out, "the US is no longer the lone policeman on the beat; the UK and other European governments have implemented anti-corruption regulations too, as have emerging economies including China and Brazil."

The same report highlights a 2013 estimate from the World Bank of $1 trillion worth of worldwide bribes a year. That's more than half the GDP of Canada and about $135 for every person on the planet.

We have a problem. It needs addressing. And the authorities, as well as your customers, need to see that you have systems in place to tackle it.

But solutions and processes are at hand.

Risk specialists such as Datta recommend starting with a simple audit of your technology, personnel, strategy and risk exposure to third parties. Ultimately, would you pass the "newspaper test"?

When you've built the foundations, he suggests starting an internal project team, working across the organisation for this common purpose rather than in self-contained silos.

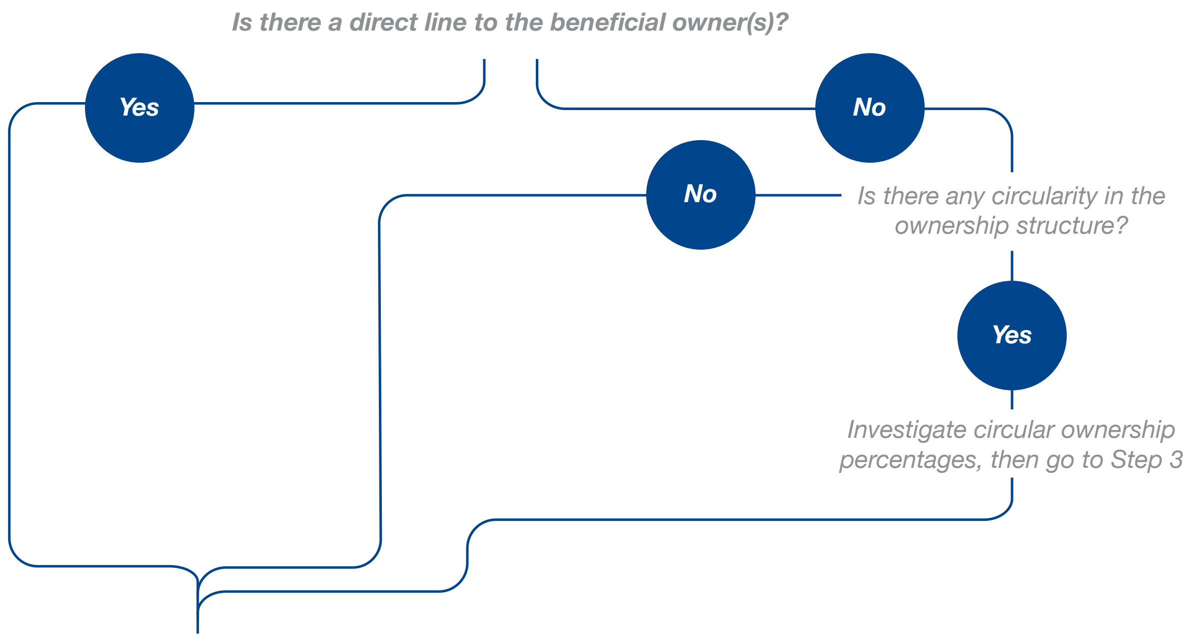
Beyond that, you need the right technology and data, and sensible internal communication channels for disseminating your decisions and reasoning.

With the right tools, the core parts of the process can be summarised by the flowchart below. Some of the resulting decisions you might have to make will be tough but at least they'll be informed.

Sounds straightforward – and it actually *can* be. (See over for a diagram that summarises the process.)

Checklist: the main steps you should take in third-party due diligence

1. Confirm existence and official name of entity (company)
2. Investigate entity's current corporate ownership structures and directorships



3. From Step 2, establish: the countries associated with the group; the company's directors; its beneficial owners; and its (other) controlling shareholders
4. As components in your risk model, check whether:

	On any sanctions list	*A politically-exposed person (PEP)*	*Connected with adverse media*	*A state-owned company (SOC)*
The entity (company) in question is	*Reg + Rep*	*NA*	*Rep*	*Reg + Rep*
The countries where the entity in question and any other companies in the group are registered are	*Reg + Rep; NB some countries, e.g. Russia, aren't sanctioned as a whole but many individuals and entities within them are*	*NA*	*Rep*	*NA*
Any director is	*Reg + Rep*	*Rep*	*Rep*	*NA*
Any beneficial owner is	*Reg + Rep*	*Rep*	*Rep*	*NA*
Any (other) controlling shareholder is	*Reg + Rep*	*Rep*	*Rep*	*NA*

Key: Reg = regulatory risk Rep = reputation risk

5. Feed your findings into the next stage of your risk model, tailored for:
   a. Applicable domestic and international laws, regulations and guidelines
   b. Internal information on your third parties
   c. Your risk appetite
6. Make a decision and check your audit trail
7. Set up an alert to monitor the entity for any future changes to its name, directorships, corporate ownership structure etc, which could prompt a fresh assessment
8. Communicate your decision internally and, where appropriate, externally

Contacting Bureau van Dijk's compliance team

With offices around the world, we'd be delighted to talk to you about your third-party due diligence risk assessment needs.

Please call us on one of the numbers shown in the link above or email **bvd@bvdinfo.com**.

orbis

The Orbis database contains information on nearly 200 million private companies around the world, as well as all listed companies. Among other things, it contains standardised company financials, financial strength indicators, directors and corporate ownership structures.

compliance catalyst

Compliance Catalyst is a risk assessment tool that streamlines 'Know Your Customer' (KYC), Anti-Money Laundering (AML) and reputation risk research, and helps with client on-boarding and customer due diligence. We created Compliance Catalyst to help our customers use the 'compliance critical' information in our products more efficiently. It pulls relevant data from our Orbis/Mint Global databases and customers' own data into a tailor-made platform.

About Bureau van Dijk

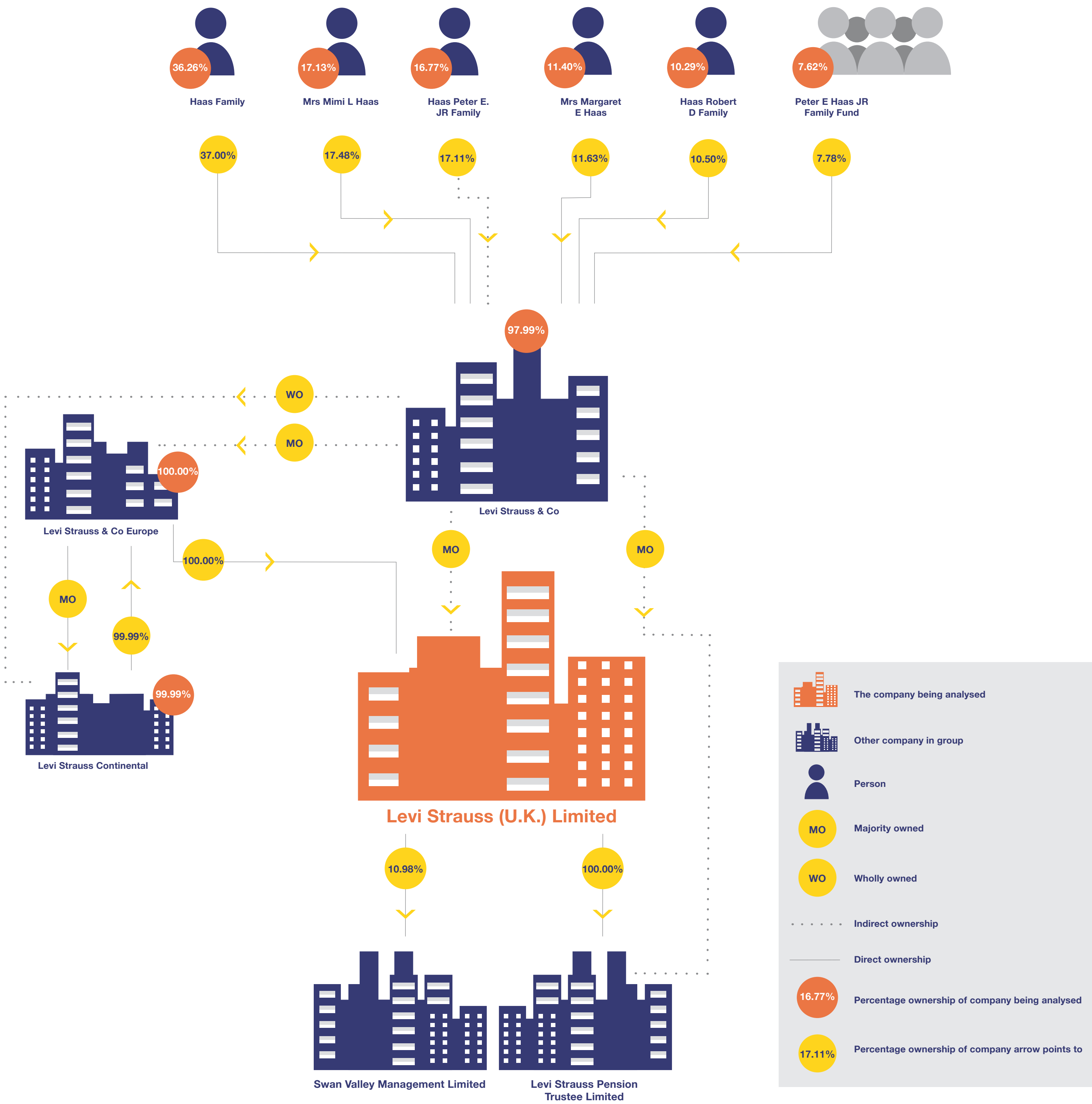
Bureau van Dijk (BvD) is the leading provider of private company and corporate ownership information. Bureau van Dijk combines, links and adds value to data from regulatory and other sources, including 140 information partners. The result is comprehensive, standardised global information provided across a range of interfaces and solutions that can be blended with users' data and integrated into their workflow. These include Bureau van Dijk Custom – bespoke solutions.

Appendix:

example ownership structure of a family of companies

Ownership structure for Levi Strauss, with the focus on the company in the UK

As of February 2016



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