

Look before you leap  
Managing risk in global  
investments





# Executive summary

As North American companies continue to explore growth opportunities abroad, most notably in emerging markets, we are observing that compliance and integrity risks appear to be rising sharply, a perception supported by our survey. Whether this foreign activity involves acquisitions, investments, or other business relationships, such as joint ventures, its deployment in regions often previously unknown has raised the stakes for corporate strategists and compliance officers.

While most executives are familiar with the categories of compliance risk — integrity and reputation, corruption, violation of economic and trade sanctions, and money laundering — expansion into the less developed regions of Asia, Central/Eastern Europe, and others is heightening the potential for those risks to become reality. More than ever, “look before you leap” should be at the top of the agenda for corporate acquirers.

To gain greater insight into this issue of growing concern, Deloitte and Forbes Insights conducted the 4th annual *Look Before You Leap* survey. Participants included more than 500 business professionals at companies in the United States, Canada, and Mexico with a focus on surveying companies in the financial services industry. Participants represented a wide range of industries, with 39% of the respondents in the financial services industry, including both financial buyers, such as private equity firms and hedge funds, and strategic buyers.

In addition, several one-on-one interviews were carried out with senior executives responsible for corporate planning or compliance in order to explore particular concerns in greater detail.

Some of the key research findings include:

- Almost two-thirds (63%) of total survey respondents identified Foreign Corrupt Practices Act (FCPA) and anti-corruption issues that led to an aborted deal or a renegotiation over the past three years. Lack of transparency or unusual payment structures in contracts was cited by one in five and 18% pointed to the use of agents, consultants, distributors, or third parties to obtain or facilitate business.
- The level of concern over the potential for compliance and integrity-related risks has increased substantially over this period, especially in the areas of integrity and reputation. Eighty-five percent of respondents said their concerns had risen significantly or somewhat.
- A clear majority (60%) of respondents said that they have either pulled out of a transaction or adjusted deal pricing to reflect compliance and integrity-related issues. A similar proportion required a target or partner to resolve and/or disclose a compliance issue to regulators prior to closing.
- China is highest on the list of countries or regions ranked according to concerns about the potential for compliance and integrity-related issues when doing business. More than 80% of respondents said they were significantly or somewhat concerned about China. Mexico and Central and South America ranked second and Southeast Asia (Vietnam, Indonesia, and the Philippines) was third.
- Entities from Mexico appear to be very finely attuned to compliance and integrity due diligence issues, and highly confident in their ability to meet the challenges. More than 90% of respondents from Mexico said they identified issues in the diligence process in each of the four risk areas mentioned above.

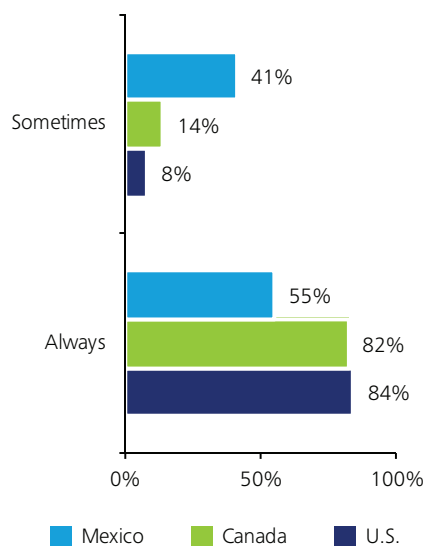
Financial services firms made up almost 40% of the survey universe and the more interesting results from this sector are as follows:

- Almost two-thirds of these firms have identified an economic and trade sanctions issue that caused a transaction to be discontinued or renegotiated over the past three years. One senior commercial banker interviewed on this topic recalled a proposed wealth management acquisition that was abandoned after his bank found “a concentration of nationalities that did not appeal to us.”
- Nearly half (45%) of financial services respondents reported finding issues related to ineffective or limited scope of sanctions screening procedures, systems, and controls. Around one quarter mentioned lack of adequate Office of Foreign Asset Control (OFAC) or economic and trade sanctions compliance programs.
- More than two-thirds (68%) of financial firms identified deficiencies in anti-money laundering (AML) and terrorist financing compliance controls that would require significant remedial attention. Know your customer (KYC) deficiencies and weaknesses in AML transaction monitoring systems and controls were mentioned as most prevalent.
- Nearly 80% said they conduct very or somewhat detailed due diligence on the compliance programs and controls of acquisition targets or potential partners.

# Few exceptions to due diligence

Not surprisingly in view of the heightened risk climate, an overwhelming majority of companies surveyed said they always conduct compliance and integrity due diligence before entering into a foreign transaction. More than 80% of respondents in the United States and Canada fell into this category, indicating that due diligence is a core part of decision making throughout the deal process.

## How often does your company conduct compliance and integrity due diligence of relevant parties before entering into a foreign merger, acquisition, or business relationship?



When issues related to mergers and acquisitions (M&A) transaction did arise, 60% of those surveyed said they learned about them during due diligence compared to 18% who found issues during target identification.

“We would consider it irresponsible not to carry out full due diligence, especially in cases where we are choosing a long-term joint venture partner abroad who will be in control of day-to-day operations,” said the chief compliance officer at a major U.S. multinational corporation. “The only exception would be a hostile tender offer on our part in an attempted acquisition.”

That sentiment was echoed by Ray Risco, vice president, international operations, at Weyerhaeuser, the global forest products company. “Our due diligence process has become even more robust over the past two years as a

result of the focus by the Justice Department on FCPA as well as increased focus on corruption globally,” he said, pointing to the recently proposed anti-bribery law in the U.K. “We essentially took a process we already had one step further by formalizing and centralizing it within our legal department, applying it throughout the entire company.”

Clearly, the aim of the due diligence process is to discover potential issues as early as possible. For many the process is incremental. “Once an acquisition target has been selected and its merits, at least initially, are seen to stand up, we will be called in to carry out an initial due diligence before an indicative offer is placed on the table,” said Brian Harte, Group Compliance Officer at Royal Bank of Canada. “If the indicative offer is accepted, we will move to the next stage, looking closely at the target’s regulatory track record and client base, for example.”

Often it is the seller who will raise issues at the outset, making full disclosure early on to avoid a possible breakdown in talks or even legal action at a later stage by the buyer. No matter how issues are discovered during due diligence, this is clearly preferable to finding them after the closing of a transaction or even during post-transaction integration. Only 5% of total survey respondents reported such discoveries after the close.

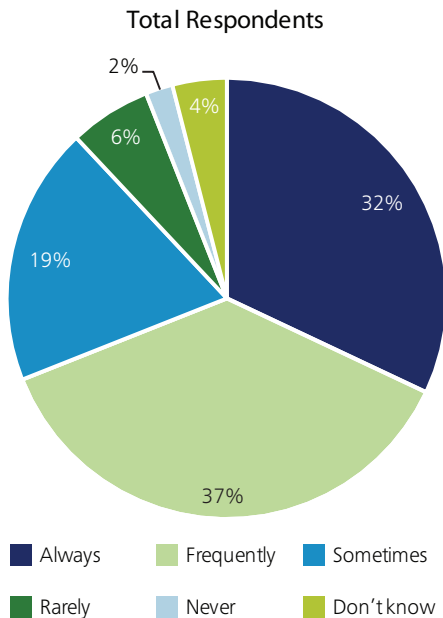
However, when the survey results from the financial services industry were broken down between strategic buyers and financial buyers, such as private equity firms or hedge funds, a slightly different picture emerged. 17% of strategic buyers said they only learned about issues during the post-transaction stage compared to just 3% for their financial counterparts.

“It can be difficult in some countries to find out early on what it is you are actually buying when, for example, the supply chain to a particular business is corrupted,” said Richard Bradeen, senior vice president at Bombardier, the Canadian aerospace and rail transportation company. “The problem is compounded because an issue like this tends to be replicated throughout a particular country. Once you know the kind of things to look for, however, the process gets a bit easier.”

# Local advice is critical

The survey asked to what extent respondents used various types of outside parties, including outside counsel, investigative firms, investment bankers, financial and financial due diligence advisors, to assist in conducting compliance and integrity due diligence process. The results showed an inclination to use external resources; 32% of the total said they always use outside counsel and 37% said they did so frequently.

## How often does your company use outside counsel to assist in conducting compliance and integrity due diligence of relevant parties before entering into a business relationship, merger, or acquisition outside of North America?



The equivalent results for investigative firms were 19% and 25% respectively; for investment bankers 24% and 35%, and for financial advisors 20% and 31%.

“For anything but the biggest deals we relay very heavily on our internal legal staff,” said the compliance chief at the U.S. multinational mentioned earlier. “Outside counsel will get involved in contract negotiations on those larger transactions but even then the work may be passed on to our in-house lawyers. It will be handled by whoever we think is most appropriate at the time.”

Others interviewed pointed to the need for local input in foreign transactions, especially in regions or countries that are virgin territory for the company. “Outside the United States, we would typically call on local advice in every case, whether that is legal or financial in nature,” said Weyerhaeuser’s Risco. “We want to make sure we are not missing anything when operating in new territory.”

Bombardier’s Bradeen also attached much importance to local resources, whether relating to language issues or local accounting practices. “We also look to people on the ground to assess the business climate of the country we are looking at and to investigate the past history of our potential target or partner,” he said.

Financial institutions looking at acquisitions in countries where they have no physical presence felt especially compelled to call on local third parties. The senior banker mentioned earlier recalled a possible wealth management acquisition abroad in which a local investigative firm was used to assess the demographics of the target’s client base. “We found what I would call a concentration of nationalities that did not appeal to us and we did not pursue the transaction,” he said.

# Deciding when to pull out

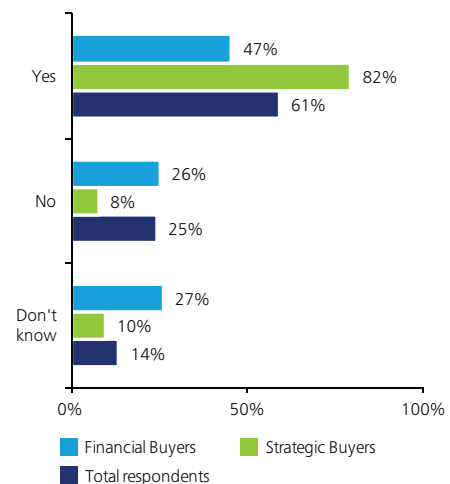
In cases where action needed to be taken as a result of due diligence revelations, survey constituents were asked what form that action took. 61% of the total said they had pulled out of the transaction and a similar proportion (60%) said they had adjusted the deal pricing to reflect compliance and integrity-related issues (for example, increased compliance costs impacting future maintainable earnings).

Other issues requiring action also proved to be significant, demonstrating the need to consider these in every transaction. For example, 60% of respondents said they required the target or partner to resolve and/or disclose to regulators a compliance and integrity issue prior to closing. The same proportion required an adjustment in the deal structure and/or non-price terms and conditions (for example, structured around certain operations, uses indemnifications, representations, and warranties).

Just over half (53%) said they terminated certain vendor, client, and/or distribution channel relationships after closing the deal. On another issue, 48% said they required the incurrence of an investigation, remediation, and/or increased compliance costs on the part of the target or partner.

Among strategic buyers in the financial services industry, however, the number taking action was noticeably higher in all categories. 82% said they pulled out of a deal compared to under half (47%) of financial buyers, while 78% said they adjusted deal pricing compared to 50% for financial acquirers.

**Over the last 3 years, has your company ever pulled out of a possible business relationship, merger, or acquisition outside of North America as a result of information identified on the target company or its principals during compliance and integrity-related due diligence?**



It is worth noting in this context that only 62% of strategic buyers said they always conduct due diligence before entering into a relationship, while 82% of financial buyers said they did.

Principal reasons for breaking off a deal or renegotiating the price were material misrepresentations or omissions (cited by 37% of total respondents) and the reputation and risk profile of the target company and its principals (33%). These figures were even higher among financial industry in general (43% cited reputation and 41% cited misrepresentations) and both factors loomed large in discussions with individual executives.

False accounting and misstatements regarding sales figures were cited by several interviewees as issues not just among emerging market companies, but also in Western Europe. "In Italy, for instance, it is still not uncommon for a company to keep two sets of books, one for internal purposes and one for outsiders," said the U.S. multinational compliance chief. "In Eastern European countries like Bulgaria, the situation is far worse. Local businesses seem to be making their numbers when in fact they are artificially boosting sales, through promotions, for instance."

Those interviewed agreed that the reputation of a potential partner is critical to the success of a transaction. “This is the most important issue from our perspective,” said Bombardier’s Bradeen. “If we don’t like the risk profile of a target, we won’t even begin discussions. How do we assess reputation? By talking to accountants and bankers with whom we do business in the country, talking to people who already deal with the target, [and] looking for litigious action by the target in previous deals.”

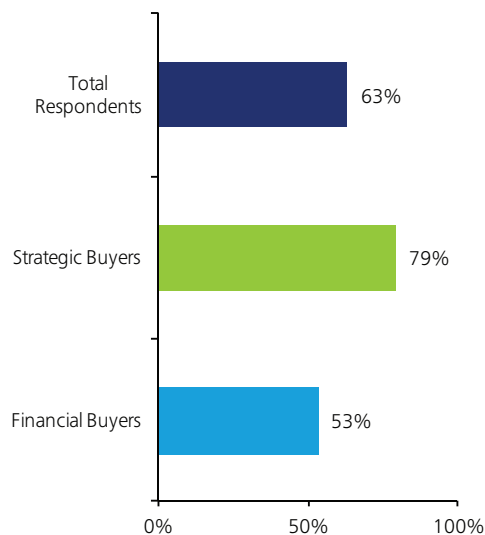
Reputation can be an even weightier factor in the financial services industry, as was the case in the aborted wealth management acquisition mentioned earlier. In transactions such as these, acquirers should consider looking closely not just at the target or partner’s existing client base, but its past due diligence process in taking on new clients. As for risk, in our experience a factor often overlooked in financial services deals is the corporate culture of both parties. Investment banking can be a prime example of the potential for culture clashes.

On the other hand, issues related to foreign governments did not appear high on the list of integrity and reputation issues. Only 17% of respondents mentioned political links and relationships with government officials as a factor and 15% cited direct or indirect foreign government ownership interests. Those interviewed indicated that while part ownership by a foreign government might increase reputational risk, it would not in itself be a deal breaker. Further, in certain strategic industries, such as defense, some degree of government involvement is probably inevitable.

# Corruption issues remain a concern

As mentioned at the beginning of this report, almost two-thirds (63%) of total survey respondents identified FCPA and anti-corruption issues that led to an aborted deal or a renegotiation. As with integrity and reputation issues, the proportion of strategic buyers impacted by FCPA was much higher (79%) than that of their financial counterparts (53%). The principal FCPA issue cited (by one in five of total respondents and by one in three of strategic buyers) was a lack of transparency or unusual payment structures in contracts.

## Percentage of respondents that identified FCPA and anti-corruption issues that led to an aborted deal or a renegotiation.



Ranking second was the use of agents, consultants, distributors, or third parties to obtain or facilitate business, an issue that Weyerhaeuser's Ray Risco placed at the top of his list of concerns. "While it is relatively easy to manage our own employees, it is much harder to control those outside the company. We work at this by, among other things, being very specific in our contractual language, especially with regard to behavior, and then following up with an option to review what the outsiders are doing."

A strong undercurrent of concern about bribery in what the U.S. multinational executive termed "troublesome"

countries ran through the discussion on FCPA. "Tribal loyalties in a country like Nigeria are often greater than loyalty to the employer," said this executive. "There are limits as to how successfully you can limit graft at the local level, even with all the controls you can muster. The only answer is to audit frequently and be a constant presence in that capacity."

Payments by potential targets or partners to government inspectors or customers in the interest of avoiding tax payments or gaining new business, for example, a clear violation of FCPA, are not unusual in such countries. This may explain why 15% of survey constituents mentioned "unusual business relationships between executives at the company and government officials or third parties" as an FCPA issue.

A similar question was asked relating to economic and trade sanction issues that gave rise to problems over the past three years.

Almost two-thirds (64%) of financial services industry respondents confirmed that they had encountered issues of this nature. More than one in three (35%) of these respondents identified weaknesses in due diligence, screening, and compliance programs and one in five (21%) pointed to operations exposed to high-risk countries that had connections with regimes subject to international sanctions.

# Money laundering a particular issue for financial services

Half of total respondents pointed to money laundering issues in the due diligence process, but the proportion was higher (59%) among financial industry firms, a trend underscored in individual interviews.

Almost 80% of strategic buyers said they found money laundering issues, compared to 46% for financial buyers. About one in three (34%) of strategic buyers and 18% of the total cited deficiencies in AML compliance controls that would require significant remedial attention.

Other specific issues mentioned were high-risk businesses (e.g., wealth management) which would require additional compliance costs going forward and high-risk client segments that might have to be abandoned (such as gaming and money services businesses, private wealth management, and property). In all categories, the impact was felt more strongly by financial industry firms.

Since financial industry companies typically need to pay particular attention to compliance control deficiencies, respondents from this sector were asked to identify specific issues with AML and terrorist financing controls that would require remedial attention. Sixty-eight percent of these firms said they had encountered issues of this kind and 38% pointed to customer identification, due diligence, or KYC deficiencies. Thirty-five percent pointed to weaknesses in AML transaction monitoring systems and controls.

## **“Financial services firms have issues of their own”**

By the very nature of their business, banks, brokerage houses, insurance companies, and other entities dealing in money should be especially careful when doing business outside of North America. The imposition of economic and trade sanctions by the United States in recent years and much tighter controls over money laundering introduced by numerous developed countries have made the task of compliance increasingly challenging.

Since the financial crisis first erupted in late 2007, commercial and investment banks in particular have been facing the added burden of increased scrutiny by national regulators. “As an industry we have to be far more cognizant of the regulatory environment than others,” noted one U.S. banker.

This sentiment may partly explain why the research showed the financial industry to be concerned by compliance issues. Asked about the degree of detail in their compliance and integrity due diligence prior to entering into a business relationship abroad, the proportion of financial services firms citing “very detailed” was higher than that of total respondents in eight out of the ten categories listed.

The financial industry remains concerned about money laundering in particular. Asked whether their level of concern over the potential for compliance and integrity risks in this area had changed over the past three years, 38% of financial industry firms noted significantly increased concern compared to just 30% of the total universe. The interviews showed that while some firms feel they have appropriate KYC procedures in place, the same may not be true of potential targets or partners.

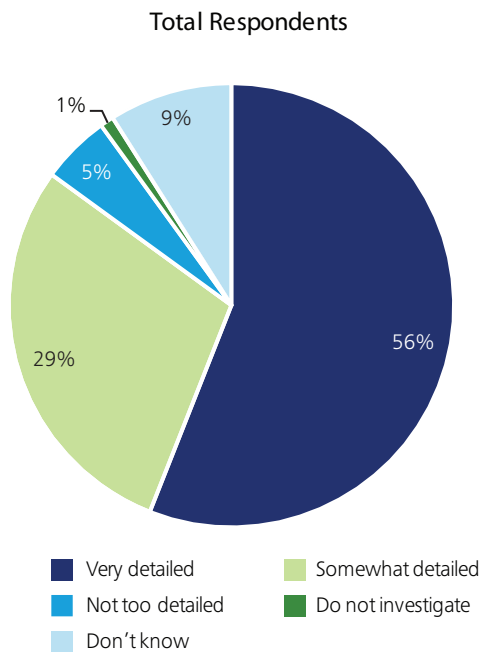
“In any prospective acquisition we look very closely at the procedures in place for vetting new customers and for being in compliance with whatever laws and regulations we believe apply or are necessary,” said Royal Bank of Canada’s Brian Harte. “And if there is an identified flaw in the controls we need to know what is being done to address that, and when it will be rectified.”

On the question of economic and trade sanction compliance, another issue of particular concern to financial industry companies, we asked them which weaknesses in due diligence they had identified that caused them to pull out of or renegotiate a transaction. Almost 70% said they had come across issues of this kind and 45% cited ineffective or limited scope of sanctions screening procedures, systems, and controls. Around one-quarter (26%) mentioned lack of adequate OFAC or economic and trade sanctions compliance programs.

# Risk concerns generally increase attention to detail

Respondents were asked how much detail they sought in the due diligence process outside North America with regard to 10 different issues. The category drawing most attention was the legal, regulatory, and control environment in the countries where the target or partner operates; 56% said their approach was very detailed and 29% described it as somewhat detailed.

**When your company conducts compliance and integrity due diligence before entering into a business relationship, merger, or acquisition outside North America, how detailed is the investigation of the legal, regulatory, and control environment?**



Other issues of major importance were criminal or administrative violations imposed by a government agency (50% and 30% respectively) and the background and reputation of the key principals, executives and management (49% and 31%). The extent of the entity's international operations, sales and business relationships in high-risk countries also merited extra detail (46% and 34%). Client and business relationships with higher risk industries (including gaming, energy and technology, among others) were ranked lowest among the issues (38% very detailed and 36% somewhat) but still a significant factor.

The push for greater detail almost certainly has its origins in heightened risk concerns. The survey asked how the level of concern over the potential for compliance and integrity-related risks has changed over the past three years in four key areas: integrity and reputation, FCPA/anti-corruption, economic and trade sanctions, and money laundering.

Eighty-five percent of total respondents said their concern over integrity and reputation risk had risen significantly or somewhat during this period, although those in Mexico were virtually universal in seeing an increase, whether significant or not (see "The Mexico Enigma" sidebar below). The proportion was even higher among strategic buyers, with 92% saying their concern over integrity and reputation risk had risen significantly or somewhat.

Concerning FCPA and anti-corruption risk, 69% of the total cited an increase of some kind, although concerns were much lower among U.S. and Canadian respondents (63% and 51% respectively) than they were in Mexico (96%). Once again, strategic buyers expressed greater anxiety on this score with 80%, compared to 63% for the financial buyers.

A similar pattern prevailed when considering economic and trade sanctions and money laundering. In both areas, respondents from Mexico demonstrated much deeper concern (showing increases among almost 100% of constituents in both categories) than their counterparts in the United States and Canada. Increased concern over sanctions risk was cited by 57% of U.S. respondents and a similar proportion in Canada, while money laundering attracted a 48% score in the United States and 51% in Canada.

As with integrity and reputation, money laundering risk is causing concern among financial industry firms; 72% cited heightened concern. And strategic buyers continued to rank higher than their financial counterparts, with 81% demonstrating increased concern in this area compared to just 65%.

### “The Mexico Enigma”

For those who might imply that standards of compliance among companies from Mexico are lower than those North of the border, research for this paper produced a firm rebuttal. In their foreign business relationships, Mexico-based entities appear to be very finely attuned to the issues involved in compliance and integrity due diligence and highly confident in their ability to meet the challenges.

Consider the following survey results:

- Although only 55% of survey respondents said they always conduct due diligence (41% said “sometimes”), more than 90% said they identified issues during that process in each of the four key areas: integrity and reputation, FCPA and anti-corruption, economic and trade sanctions, and money laundering. This proportion was much higher than the equivalent for the United States and Canada.
- Around 75% of respondents from Mexico had pulled out of a deal or renegotiated it as a result of information obtained during due diligence, also a substantially higher number than the other countries. Indeed that pattern was repeated in every category of action taken.

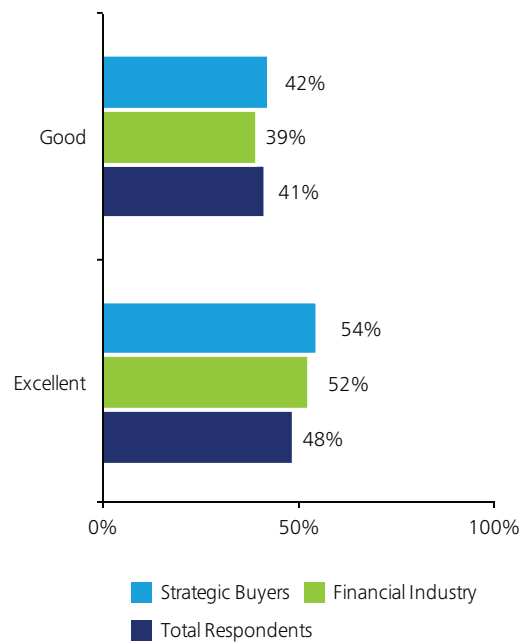
- No less than 94% said they identified money laundering issues during due diligence and 97% came across deficiencies in AML and terrorist financing compliance controls. Comparative figures for the United States and Canada were around 36% in the first category and 62% in the second.
- Asked to assess their skill levels in conducting compliance, almost 100% of companies from Mexico applied an excellent or good rating to themselves in each of the four areas. Fifty-five percent rated their skills as excellent with regard to FCPA and anti-corruption and 49% did the same with money laundering.
- While only 31% said they were extremely concerned about the potential for compliance issues when doing business in their own country (Mexico), Central and South America, 50% expressed extreme concern about China, and 49% responded in similar terms regarding Pakistan and 48% pointed to Southeast Asia.

Many might be surprised by these findings. But one senior executive at a U.S. private equity firm specializing in Latin America had this to say: “I can completely understand these responses. First, disclosure requirements for public companies in Mexico have been noticeably increased in the last few years; the introduction of periodic reporting of derivatives positions is just one example. That has heightened awareness of compliance issues generally.”

# An expression of confidence

Faced with rising compliance risk, how well equipped are North American companies to conduct effective due diligence? Using the same four categories mentioned above, the survey asked how adept respondents believed their organization to be at conducting compliance and integrity due diligence.

## How adept is your organization at conducting compliance and integrity diligence in the area of integrity and reputation?



No less than 89% of the total respondents rated their company's skills as excellent (48%) or good (41%) in the field of integrity and reputation. Financial industry firms ranked themselves slightly higher at 91% (52% and 39%) and strategic buyers appeared confident of meeting their increased risk concerns with a 96% response (54% said excellent and 42% said good).

On the question of FCPA and anti-corruption, 82% considered their skills to be excellent or good. Once again, financial industry companies scored slightly higher with 85% and strategic buyers came in with 92%. The pattern with regard to economic and trade sanctions was similar; 80% of the total ranked their capabilities as excellent or good; financial industry firms scored 82% and strategic buyers had another 92% ranking.

However, on the issue of money laundering, the level of expertise was deemed to be the lowest among the four categories. Less than three quarters (74%) of the total rated their capabilities as excellent (37%) or good (37%) and in Canada the proportion dropped to 60% (24% and 36% respectively).

Survey constituents were also asked if they have a standard compliance and integrity due diligence playbook that guides the diligence process in the four areas mentioned. Surprisingly, only three quarters of the total responded in the affirmative with regard to integrity and reputation and the proportion dropped to 65% in respect of money laundering. In Canada, one quarter or more said they did not have a standard playbook in any of the four categories.

In Mexico, however, more than 90% said they had a playbook for integrity and due diligence, 84% indicated the same for economic and trade sanctions, and 83% had a playbook relating to money laundering. In the "no" category, one in five said they did not have standard guidelines for anti-corruption compliance.

# Where are the danger zones?

North American companies have traditionally sought acquisitions and other business relationships in Western Europe, Latin America, and developed countries in Asia, such as Japan. But in recent years, investment flows have shifted towards emerging markets, notably in Asia and Eastern Europe, as economic growth in these countries continues to outstrip growth in the developed world. This changing pattern brings with it exceptional challenges in the area of compliance and integrity due diligence.

In extreme cases, the requirement for extra caution is all too obvious. The survey asked whether a heightened level of due diligence is required when doing business in countries (such as Iraq or Haiti) that are undergoing rebuilding efforts as a result of war or natural disasters. In every category of respondent, 90% or more said yes.

Questioned as to what potential type of malfeasance is of most concern when doing business in these countries, over half (51%) of the total mentioned FCPA and corruption. Just under one-third (30%) cited integrity and reputation and only 9% said money laundering was an issue.

Of course, actual investment in countries such as those undergoing rebuilding efforts is minimal compared to major destinations like China, India, and Russia. The survey asked about concern over compliance and integrity-related issues when doing business in 12 countries or regions, ranging from the three above-mentioned to Mexico, Central and South America, Africa, Central, Eastern and Western Europe, Japan, Middle East, Southeast Asia, South Korea, and Pakistan.

Over half (53%) of the respondents said they were extremely concerned about the potential for issues in Pakistan and 49% said the same about the Middle East. Russia and the Commonwealth of Independent States (former members of the Soviet Union) ranked third on the list of concerns. However, when “extremely” was combined with “somewhat” concerned, China emerged in first place with 81% (44% extremely concerned and 37% somewhat).

Using that methodology, Mexico and Central and South America ranked second with 76% (35% extremely concerned and 41% somewhat) and Southeast Asia (Vietnam, Indonesia, and the Philippines) was third with 74% (33% and 38% respectively). At the other end of the

scale, only 40% expressed any degree of concern over Japan and 43% said the same about Western Europe.

In discussions with chief compliance officers and corporate strategists, Russia and the CIS, China, and India were most often mentioned. This is hardly surprising since these three regions are major destinations for investment capital. Russia and its former satellite republics in particular are singled out for corruption. “Bribery is endemic in Russia and in Ukraine, where you cannot complete a plant or import a new product without paying someone off” said the U.S. multinational executive.

Others pointed to past practices, such as price-fixing in Eastern European countries that tend to have a habit of resurfacing. “It’s a different way of doing business that you might assume disappeared after the collapse of the Soviet Union,” said one compliance chief. “Then you have the issue of individuals in these countries that may have a “history” under the old regime. They appear to be adopting conventional compliance but when you investigate their past it is far from conventional.”

Transparency International’s Corruption Perceptions Index is closely watched by potential acquirers and others seeking to do business in developing countries. But Weyerhaeuser’s Risco said that while the Index is “directionally correct,” a higher place in it does not necessarily mean that all activity in that particular country should be tarred with the same brush. “It varies by industry, by size and by geography,” he said. “A major corporation like ours has high standards and controls that deter inappropriate activity. Smaller, regional companies might be comfortable with lower country standards it considers to be normal.”

# Financial buyers less worried

In almost every country or region, financial acquirers in the financial services industry were much less concerned about compliance issues than their strategic counterparts. No less than 91% of strategic buyers acknowledged concern of some kind over China compared to 74% of financial buyers. Russia and the CIS attracted an 85% concern rating from the strategic side compared to 69% and for India the respective figures were 83% and 66%.

One reason for this discrepancy and for heightened concern among strategic buyers over compliance issues in general may be better local knowledge on the part of private equity firms, although that is open to debate. Some of these firms have local offices in the emerging market regions of Asia and Central and Eastern Europe, typically

staffed by nationals of the particular country. In order to source investment transactions at the local level, they need to be engrained in the business and cultural life of the country.

Strategic or commercial buyers may not have that knowledge to hand if they are entering a new market outside the developed world. “Their first priority is to find and implement synergies with a target acquisition, assuming it is in the same industry,” said one U.S.-based private equity executive. “They need a clear action plan setting out the savings in detail so they know what price they can afford. In that context they may well overlook local compliance and integrity issues, at least initially.”

## What separates financial and strategic buyers?

A closer look at the survey results from the financial services industry reveals how the attitudes of these two types of acquirers differ in their approach to overseas acquisitions. Financial buyers, including, but not limited to, private equity firms, hedge funds and private individuals are likely to be primarily interested in the returns they can achieve over time by investing in a business. Strategic acquirers, on the other hand, are generally seeking an entity that fits into their long-term business plans, resulting in synergies that produce (sometimes substantial) cost savings.

Overall, the survey found that strategic acquirers had greater concerns over the various compliance issues and were more likely to pull out of a deal or take some action prior to closing as a result of information obtained during due diligence. Over 80% said they had aborted a deal compared to less than half among financial buyers. In five other categories of remedial behavior (ranging from renegotiation to terminating certain vendor or client relationships), strategic buyers demonstrated a greater propensity to act.

The same disparity occurred when questioned about issues that prompted such action. In each of the three major categories — integrity and reputation, FCPA and anti-corruption, and economic and trade sanctions — a much greater proportion of strategic buyers encountered problems than did financial acquirers. Ninety-three percent found integrity issues, 79% encountered FCPA hurdles, and 82% did the same with respect to economic and trade sanctions.

Yet the strategic sector appeared exceptionally confident about its ability to conduct compliance and integrity due diligence. In each of the four areas (the three mentioned above together with money laundering), over 90% of strategic buyers rated their competence in carrying out due diligence as excellent or good. By contrast, the highest proportion among financial buyers was 86% in the field of integrity and reputation. With regard to economic and trade sanctions, the proportion citing an excellent or good level of skills dropped to 73%.

Financial buyers may have better local knowledge when researching foreign business relationships; strategic buyers may be more focused initially on the synergies (short- and long-term) that they hope to extract from an acquisition. But in both cases, the challenges are likely to intensify, as the main report shows.

# Compliance as a state of mind

This report has laid out some of the key compliance issues facing North American companies as they seek to acquire or establish business relationships abroad. As they enter new territory, the risks can only grow and while awareness of these risks is also increasing, it might be a hard fight to keep pace. In talks with individual executives, for example, three particular issues were raised that may pose a hidden threat to many acquirers.

**1. Anti-trust compliance.** The U.S. and the European Union have had strict anti-trust legislation in place for many years. Memories of the Archer Daniels Midland price-fixing scandal in the mid-1990s are still fresh in the U.S. Authorities in both regions look set to make this legislation even stronger, which means that acquirers in Eastern Europe, for instance, should consider possible dubious practices, such as price-fixing.

**2. Anti-corruption compliance.** FCPA is on everyone's lips and now the UK is readying its own Bribery Act that is generally viewed as being broader in scope than FCPA. Also, the UK Serious Fraud Office is now adopting enforcement strategies that are similar to those of the U.S. Department of Justice. "The real problem though," said one compliance officer, "is that the toughest rules in the world cannot rule bribery out."

**3. Export control compliance.** Export Administration Requirements (EAR) impacting U.S. exports to countries, such as Iran and Syria, are likely to increase in scope, as the U.S. government adds to the number of companies and individuals on the forbidden list.

Keeping abreast of regulation in these areas is hard enough for North American companies on their home ground. How can they ensure compliance in foreign territories? "Many foreign businesses we talk to don't even think about it and that applies to Western Europe as well," said the U.S. multinational executive. Compliance needs to be part of the corporate doctrine, a permanent state of mind."

While by no means all-embracing, the following guidelines might help foster the compliance process:

- Consider involving other departmental units (finance and legal, for example) in the compliance process.
- Potentially call on outside resources where necessary, whether these are legal, investigative, or language specialists.
- Think about tapping into local country or regional networks when assessing the reputation and integrity of a potential target or partner.
- As part of that assessment, you may want to check with competitors and with those currently doing business with the target.
- Also consider checking the background of top executives for possible past civil and criminal problems, reputational issues, as well as litigious legal action.
- If making a financial services acquisition, you may also take into account the target's own due diligence processes regarding its existing and prospective clients.

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