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ASSESSING THIRD PARTY RISK

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Buenos Aires
September 27, 2017

Latest Guidance from U.S. Dept. of Justice

- In February, 2017 the Fraud Section of the U.S. Department of Justice released a document entitled “Evaluation of Corporate Compliance Programs.”
- The stated purpose of the document is to provide “sample questions that the Fraud Section has frequently found relevant in evaluating a corporate compliance program.”
- The document employs a checklist format and covers eleven “sample topics and questions.”

Latest Guidance from U.S. Dept. of Justice (cont.)

- On Third Party Management, the document highlights:
  - Analysis of corporate criminal enforcement actions in the past few years, especially in the FCPA context, demonstrates that third parties continue to present a significant risk for any business;
  - Special emphasis is placed on the processes that a company implements to manage this type of risk. The DOJ expects companies to manage its third parties in a manner that corresponds to the nature and level of the enterprise risk, and to integrate the process into its procurement and vendor management systems;
  - The DOJ will seek to determine whether a company has carefully evaluated whether using third parties is necessary or advisable at all, given the particular risks faced, and how those third parties are compensated. Companies should be also prepared to present and discuss hard data on this subject;
  - Typical questions to be expected in this context:

    - *When red flags are identified, how does the company respond?*

    - *Have third parties been rejected by the review/approval process for red flags. If not, why not?*

The Four Stages of the Third Party Management Cycle

STAGE 1: Identification and Qualification

STAGE 2: Engagement and Contracting

STAGE 3: Monitoring and Auditing

STAGE 4: Exiting the Relationship

STAGE 1: Identification and Qualification

- Selection criteria
  - Experience, qualifications, unique expertise, recommendations, etc.
  - “Lowest Price Bidder” does not have to be a deciding factor, but Fair Market Value is a must-have
- Due diligence
  - What kind of due diligence?
  - Tiered based on risk level
  - How do you determine the risk tiers?
  - What about “red flags”?

STAGE 1: Identification and Qualification (cont.)

- Risk tiers
  - Conduct risk assessment on the third party to determine the type of due diligence you need to undertake
  - Assign points (i.e. a scorecard) based on answers to questions such as:
    - What is the percentage of sales to the government versus the private sector?
    - Will the third party interact with healthcare professionals or government officials on your behalf?
    - Is this a private entity or a government entity? Is it publicly traded? How many shareholders?
    - Where are you engaging the entity? What is the Corruption Perception Index in that country?
    - Has this entity ever been trained on anti-corruption compliance? Does it have a code of conduct?
    - Any unusual payment requests (e.g. to a bank account in a third country)?
    - History/time in business/previous relationship with your company?

STAGE 1: Identification and Qualification (cont.)

- Each company is different. There is no one-size-fits-all. Design questions and risk tiers with your business model in mind.
- Once you have the risk tiers, be consistent about applying that tier's due diligence to any third party that meets the criteria.

- Tier 4 could be a simple credit check.

- Tier 3 could be tier 4 plus a reputational internet search conducted in-house.

- Tier 2 could be tier 3 plus more in-depth due diligence of public databases (such as litigation databases or criminal checks), either in-house or through a third party service.

- Tier 1 could be tier 2 plus specialized and tailored third party due diligence reports and/or background investigations.

- These are just examples. You can have more or fewer tiers, and different due diligence approaches. The goal is to have information about the third party, their reputation and their history.

STAGE 2: Engagement and Contracting

- Work with your Legal Department to ensure the contract contains adequate anti-corruption clauses, audit rights, and that it is signed before any sales or services commence.
- Ensure the third party receives Compliance training commensurate with its risk tier at the beginning of the relationship.
- Existing agreements: could be difficult to amend in order to include anti-corruption clauses – without opening the door to price increases, undesirable negotiations, time-consuming negotiations, etc.
  - ❖ Ask your Legal Department to prepare a “Compliance Commitment Letter” that can be used as a compartmentalized tool to add anti-corruption clauses, training and audit rights, etc. without opening the entire agreement up for renegotiation

STAGE 3: Monitoring and Auditing

- Third Party Management is not simply conducting due diligence and forgetting about it. Third Party Management involves actively monitoring the third party and the relationship.
- What kind of monitoring? How often?

- The strongest is full books and records audits by external auditors. It's not workable for every third party. Determine your methodology for deciding how many books and records audits you will conduct every year.

- Business reviews or distributor visits and interviews are another option to detect potential red flags. How many and how often should you be conducting those?

- Periodic evaluations and certifications of compliance with the terms of the contract, and that there have been no changes in the responses to the initial due diligence questions.

- Full due diligence renewal after a certain number of years, or sooner if circumstances require it.

- Ownership: individuals who "own" the relationship with a Third Party should be responsible for flagging any adverse findings or situations at any given time – the importance of having Third Party Compliance added to individual Goals & Objectives as well as compensation plans

STAGE 4: Exiting the Relationship

- The costs of exiting a relationship could be significant
- Many Business Sponsors are not aware of the difficulties and cost of exiting a relationship
- This should be considered *a priori* – individuals should understand that it is best not to enter into a risky relationship to begin with, since breaking away later could become costly and difficult
- Once again, the “horizon issue” is a consideration: individuals may choose riskier relationships in response to short-term incentives and rewards
  - ✓ the importance of having Third Party Compliance added to individual Goals & Objectives as well as compensation plans

STAGE 4: Exiting the Relationship (cont.)

- Legal strategy must be in place
- Decision must be aligned at higher levels – costs of exiting vs. costs and risks of NOT exiting
- Contingency plans: mitigate the impact to patients as much as possible

Key Takeaways

- Third parties continue to present a significant risk for any business;
- Third Party Management is an ongoing cycle;
- Companies must implement processes to manage this type of risk in a manner commensurate with the nature and level of the enterprise risk;
- Procurement and vendor management systems should incorporate this type of risk management;
- Be prepared to show that a concerted effort was made to proactively identify third party risk (due diligence, monitoring) and manage it appropriately

Q&A