



# **Submission to the Woolf Committee**

by

**Transparency International UK**

and the

**TI 'Defence Against Corruption' Project Team**

**October 2007**

## Summary

Transparency International UK welcomes the invitation to submit comments to the Woolf Committee. We believe that in setting up this Committee, the BAE Systems Chairman and Board looking for implementable recommendations that will place it in a leadership position amongst comparable industry peers, and have responded accordingly.

Our 'Defence Against Corruption' project focuses on assisting defence companies and governments together to raise their transparency, anti-corruption and anti-bribery standards. Our response is thus shaped by our experience of other companies and defence organisations, besides knowledge and engagement with BAES.

We have ordered our suggestions into a number of categories:

- i. Strengthening BAES leadership and governance
- ii. Strengthening the compliance programmes, internal monitoring and oversight
- iii. Extending the role of the external auditors
- iv. Changing company practice in respect of the use of agents and intermediaries
- v. Investigating suspected cases more vigorously, regularly reporting them to the audit committee, and disclosing internal investigation results to the relevant authorities
- vi. Rigorous cascade of business conduct practices down through the supply chains and across joint ventures.

We suggest that a good basket of comparator companies would be the following twelve: Lockheed Martin, Boeing, Raytheon, Thales, General Electric, Motorola, Shell, BP, RTZ, Anglo American, ABB, Glaxo Smith Kline.

In addition, we suggest that your Committee also needs to make proposals to the UK Government, in relation to their engagement with defence companies and government defence contracts. We are aware that this is formally beyond your scope, but we believe that BAES improvements and perceptions will be constrained otherwise. Our suggestions cover re-defining the role of the UK Government in supporting BAES, more stringent standards of transparency and integrity in government to government contracts, and strengthened oversight of the new UK - Saudi arms contract.

We believe that these suggestions, taken together with current BAES actions, will move BAES to a position at the upper end of comparison with international companies that are seen to be good in business conduct practices.

The proposals are aimed at change over the course of the next 5 to 10 years, as deep-seated attitudes and expectations, internal and external, will require several years to take effect. Nevertheless, such changes in company culture and external reputation can be achieved, as evidenced by several major companies with damaged reputations that are now well respected for anti-corruption practices and procedures.

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## SECTION 1

### Introduction

#### *Transparency International and the TI defence project*

1. Transparency International UK (henceforth TI-UK) welcomes the invitation to submit comments to the Woolf Committee. We believe that in setting up this committee, the BAE Systems Chairman and Board are making a sincere commitment to higher standards of integrity at BAE Systems (henceforth BAES), and are genuinely looking for implementable recommendations that will place it in a leadership position amongst comparable industry peers.
2. Transparency International is an international NGO committed to tackling corruption. We work through constructive engagement with government, industry and major stakeholders. TI runs an international initiative with a range of leading companies to set high anti-bribery standards across all private sector businesses; the 'Business Principles for Countering Bribery'. In the UK, TI-UK is the originator of two other international cross-country projects of the TI organisation: one addressing corruption risk in construction and engineering and one addressing corruption risk in defence. TI-UK has been engaged in seeking constructive measures to address corruption in the defence sector since 2000, when it organised conferences to discuss the issues in Sweden and then in the UK; the latter was sponsored and introduced by the Secretary of State for the Department for International Development (DFID).
3. TI is not against legitimate arms sales. We believe arms sales have their place and are a necessary part of national defence and international peacekeeping. We are engaged with tackling corruption in defence because of the historically high levels of corruption in the defence arena, and the negative impact on good governance across the rest of a nation's government from widespread defence corruption. In many cases, governments have also bought weapons systems that were not needed, because of the corruption involved.
4. The project team currently engaged with defence, the 'Defence Against Corruption' project (TI-DAC), formed at the beginning of 2004, with funding from DFID and the Swedish Ministry for Foreign Affairs and has been working in the following areas:
  - Building awareness in defence ministries, companies and among Parliamentarians that the corruption can be tackled effectively
  - Working with defence companies, encouraging them to collaborate internationally so as to build more integrity into international tendering, and to find ways to help reformist governments
  - Working with defence establishments in strengthening anti-corruption measures, particularly involving civil society.
  - Working with NATO members to use their leverage to build integrity in NATO partner countries. We are collaborating with NATO and the Defence Academy in the UK to

create a training module that will be used to develop anti-corruption capacity and competence in NATO member, accession and partnership countries.

- Working with other international bodies, such as the World Bank, to leverage defence anti-corruption knowledge and processes across many countries
- Developing tools and monitoring mechanisms for widespread use in the defence sector, with particular emphasis on procurement

### ***TI commitment to better business conduct in the defence sector***

5. There are very good reasons for governments, defence companies and civil society to address corruption specifically in the defence sector:
  - Corruption is costly and a waste of scarce resources; whether through corrupt procurement, payment of non-existent manpower, corrupt privatisations or asset sales.
  - It dramatically impacts on the combat power and operational effectiveness of the military forces.
  - It reduces public trust and acceptance of the military. Pride of the civilian and military staff in their service is seriously degraded when staff and the public know of corruption in the military
  - It reduces the credibility of national forces on peace-keeping missions.
  - Defence acts as a 'concentrator' of corruption across government. Because it can be so easy to extract money from the secretive defence sector, a corrupt infrastructure of middlemen, accountants and lawyers is kept in business.
  - Adequate security is now well recognised as one of the key conditions for growth in developing countries: corruption in both defence and security severely compromises this.
6. In this context, the UK and BAES are important players. The UK has long been one of the principal arms exporters, and the government has actively encouraged arms sales since at least the 1960s. BAES, through a process of industry consolidation, has become the leading defence company in the UK. BAES, as one of the top six worldwide, is one of the few large platform makers capable of competing globally and thus exert a strong influence, both for the good and for the worse, on defence firms and on governments in the UK and overseas.
7. BAES is of particular importance because of its involvement in a series of high profile arms deals that have been persistently subject to allegations of bribe paying. Sales to South Africa, Tanzania, Romania, Czech Republic, and above all to Saudi Arabia, have led to investigations being mounted by the UK and other nations; none have yet been completed. However, this submission is focused on constructive measures that we believe BAES and the UK government might consider: we do not comment on the various allegations.

***TI-BAES engagement***

8. From the beginning of this project, the TI-DAC team has followed a deliberate policy of engaging with BAES and have done so since early 2004 both in London and with BAES staff in the USA. Where we have proposals that we believe would be constructive for BAES we have communicated these in private to the Company at various levels.
9. We have noted in various meetings that there is a marked difference in approach between the UK and US arms of the company. The US officers of the company have been vociferous to us and to others in their support for high business integrity standards; and their peers in the US Defence industry see this commitment as credible. This contrasts markedly with the 'denial of any problem' attitude in London and elsewhere.
10. TI-DAC has put a lot of effort into calling for an international, industry wide, raising of anti-bribery standards. We have hosted meetings at about six monthly intervals to which the major defence companies from Europe and the USA have come, to develop proposals for an industry consortium or grouping to address the issue, and put proposals to them. Lord Robertson of Port Ellen, the former UK Secretary of State for Defence and former NATO Secretary General, chairs these meetings on behalf of TI. The TI-DAC team has made specific proposals to the industry outlining what we consider to be a good basis for collaboration to raise standards. These proposals 'Briefing for Defence Industry Meetings' were presented to the industry group, including BAES, on November 16th 2005 and are attached as an Appendix to this submission. TI and this industry group have facilitated the setting up of a pan-Europe initiative, coordinated by the European Aerospace association ASD. This initiative seeks to establish an agreed set of anti-bribery principles that all defence companies in Europe will sign up to. BAES is engaged in this initiative as a member of its working group.
11. Separately, BAES has set up a UK defence company best practices forum. We welcome the establishment of this group, and have on one occasion presented to it. However, it seems so far to be a meeting for an exchange of information, rather than leading towards any higher standards.

## SECTION 2

### Response regarding the broader context

12. You have asked for responses in a number of specific areas, and these are addressed in Sections 3, 4 and 5 below. However, there are three issues that are strongly interconnected with achieving high business conduct standards at BAES and which we believe also need to be addressed by your Committee. They concern:
- a. The role of the UK Government - in promoting arms sales, and in the use of government to government deals in the arms sector
  - b. Repairing national reputational damage – to the UK's image as a champion of anti-corruption work, to large UK exporting firms due to doubts about BAES and its contracts, and the wider negative impact on the OECD Convention on Combating Bribery of Foreign Public Officials in International Business Transactions that arises from the same doubts.
  - c. The past, present and future contracts between the UK Government and Saudi Arabia

These topics may fall outside the scope of your Committee. But they are an important part of moving BAES to a leadership position on business conduct in the industry, and we believe that BAES progress will be hindered if these topics are not also addressed

#### ***The role of UK Governments in promoting arms sales***

13. Arms sales have been well known for corrupt practices. The UK Governments in the 1960s recognised this as a 'fact of life' and have consistently supported arms companies accordingly. This is likely to have been no different from other governments. However, when circumstances changed in the late 1990s, with the arrival of the OECD Convention and its entry into force in 1999, it looked to outsiders as though the Government approach, and the associated relations between the Government and BAES, did not change accordingly.
14. There has been a palpably close relationship between the Prime Minister of the day and BAES, which has the appearance of being too close and bypassing normal parliamentary and executive scrutiny. We believe there are several changes in the relationship between the Government and BAES that should also be considered, and hope that you will consider such proposals as part of your remit and communicate your proposals to the Government.
15. One such area is the role of DESO. There are continuing rumours of agreements for Ministers not to be informed of DESO decisions, and other concerns about Parliamentary and executive due process being bypassed; Frank Cooper (former Permanent Under Secretary to the Ministry of Defence 76-82 during early contract agreements with Saudi Arabia) notes that the best Government policy is 'to avoid over-extensive enquiries'.

16. We welcome the Government's proposal to disband DESO, but question whether the successor organisation will simply carry out the same functions in a less visible way in two separate Departments, but with similar conflicts of interest.
17. The secrecy of this organisation and the strong perception that it harbours the 'secrets' of Al Yamamah will forever be damaging to the reputations of BAES and the Government unless there is a major change in role, governance and transparency of the successor bodies to DESO. We believe this is an area that has received little re-consideration by Government and suggest that your Committee should propose that the government carry out a review in this area.
18. A second area is the conflict of interest for public servants, deriving from the near inevitability that senior civil servants and Ministers may be employed by a defence company after they leave Government service. This interlocking relationship does nothing to improve public purposes but is motivated for commercial gain.

#### ***Government-to-government contracts***

19. Another such area concerns government-to-government. We understand that such are a necessary contractual mechanism, but we would expect that such contracts be constructed to the highest standards of integrity and transparency. This has not been the case in the past, to judge by conversations with people in the industry and the curious way the Al Yamamah contract was set up. Our understanding is that the US equivalent, called 'Foreign Military Sales', is more stringent in this regard. We suggest that your Committee consider whether something similar should be put in place in the UK and if so propose that the UK Government develop stronger model contract clauses.

#### ***Damage to the reputation of the UK and the OECD***

20. The termination of the SFO enquiry into the Al Yamamah contract has met with widespread condemnation and is having a marked impact on the UK's standing as a strong defender of integrity and anti-corruption measures internationally. There is a significant impact on the desire of other nations to prosecute for foreign bribery or to assist the UK authorities in investigating current cases. Condemnation has come from many national officials, from the OECD, from national leaders such as Thabo Mbeki, and from TI's own engagements with the UN, OECD and senior law enforcement officials.
21. UK firms have privately made known their dismay at the continuing allegations of UK wrongdoing in relation to arms sales. Many of them are strong advocates of eliminating bribery from foreign sales and operations and see their efforts as compromised, especially by the stopping of the SFO enquiry. We hope your Committee will consider in its recommendations ways in which the wider UK reputation can also be restored.
22. The UK Government has been highly proactive, in cooperation with several of the oil and mining major companies, in developing a government-industry initiative to raise transparency in the oil and extractive industries. That work, the Extractive Industries

Transparency Initiative (EITI) is now running successfully across a wide range of governments and companies. It is having a positive impact both on the ground and the credibility of the governments and companies involved. The defence sector could examine and consider this initiative for application in their environment.

### ***UK arms contracts with Saudi Arabia***

23. We believe that the best way to move forward from this position is for the UK Government to work with their Saudi counterparts to ensure that the new arms contract with Saudi Arabia is clean, is seen to be clean and to be publicly verifiable. We believe that the UK Government and BAES could actively work together with their Saudi counterparts to establish some form of quasi-governmental oversight. TI-UK has elsewhere made recent suggestions along these lines to the UK Government.
24. We believe BAES' reputation would be considerably strengthened if it were actively to support such an initiative.
25. Based on the above, it would be helpful for the UK Government and for BAES if the Woolf Committee could outline the changes that would help set the relationship between the UK Government and BAES on a firmer, more transparent footing. We are aware that this is outside the scope of the Committee. Nevertheless, changes at BAES will be constrained if there is not also concomitant change on the Government side. Thus we believe these suggestions should be passed to Government.

### **We recommend that the following be considered:**

- **The UK Government sets up a group to review the way in which Government and the Company interact, with a view to putting straight some of the peculiar governance arrangements of the past, thereby strengthening transparency,**
- **The UK Government commissions work to develop stronger business model contract for government-to-government arms sales. This work could benefit from the experience of the US Government with 'Foreign Military Sales' contracts.**
- **The UK Government considers ways to strengthen oversight of, and confidence in, the recently signed contract with Saudi Arabia. One way to do this would be to establish an oversight commission, composed of two well reputed institutions, enhanced by independent oversight, in the UK and in Saudi Arabia**
- **The UK Government finds some way to enable a full enquiry to be undertaken of the Al Yamamah contract (Para 25)**

### SECTION 3

#### **Assessment of ethical policies and practice among major corporations operating in similar business environments to BAES**

26. We recommend that the following companies form the BAES comparator set:
- In the defence sector in the USA: Lockheed Martin, Raytheon, Boeing
  - In the USA generally: General Electric, Motorola
  - In the defence sector, outside the USA: Thales
  - Outside the USA: RTZ, Anglo American, Shell, BP, ABB, Glaxo Smith Kline
27. Defence Compliance programmes in UK and European companies are generally less extensive and less demanding than in the USA. A readable overview of General Electric's Zero Tolerance Policy, for example, can be found in the April 2007 edition of Harvard Business Review, author Ben Heinemann, and has separately been given to your Committee. The TI defence project has made a comparison, using the research facilities of the Institute of Business Ethics. This is available at the TI-UK website and has been made available to your Committee.
28. Once the basic business conduct policies, processes and training are in place, the two key features of a quality anti-bribery and transparency programme are:
- The attitude across the leadership of the organisation, and
  - The thoroughness of the monitoring, investigations and follow up of allegations.
29. The leadership of companies like GE, Shell, BP, Lockheed Martin demonstrate active commitment to integrity and in this regard are about as good as they get: the top management have been pushing hard at this agenda for 30 years or more. They still have integrity problems and bribery cases, but the ethos throughout the company is strongly focused on high integrity conduct. In some cases, such as at Lockheed Martin, GE, Raytheon and ABB, the commitment to high standards developed out of a major scandal. But others like BP and Shell were successful in developing a strong business conduct ethic and practice without a major scandal.
30. Commitment to monitoring and investigations is the real test of a company. Putting aside processes, the training and reporting, is there really an active follow through by management and/or leadership when integrity problems are suspected? For example, is the senior executive in whose division a clear offence occurred fired, even if he/she knew nothing of the incident? Where there is suspicion, is it routine for there to be a thorough investigation (if needs be, with disclosure to the authorities)?
31. There are significant differences in the various legal environments, specifically between Europe and the USA. The main differences are the FCPA legislation in the USA, and the plea bargaining machinery that operates and drives legislation in the US. These differences are real but, in our view, many European defence companies overplay the legal differences to hide poorer policies and practices in Europe and to dilute improvement proposals. Whilst US Companies are generally tougher than European

ones in this respect, good comparator companies like ABB, Shell and BP are up there with their US equivalents in investigations.

32. We believe that BAES is not up to the standards of many of the comparator companies.

## SECTION 4

### **Understanding BAES as a company and its activities as a manufacturer of military equipment, its role as a major UK exporter, and the legal framework – both domestic and international – in which the company operates.**

33. BAES is a major UK manufacturer and a creator of jobs. We note, however, that the Defence Sector has been treated differently from other industry sectors for decades. The UK Government has been actively supportive, including the need to pay bribes as required, since at least the 1960s. Because BAES is the only world-scale 'prime contractor' in the UK, it thus has inevitably privileged relationships with the UK Government.
34. The UK Government has long pushed for UK defence companies to export. This is because the UK Government works hard to keep acquisition prices low in the UK, and encouraging companies to reap higher margins on overseas contracts enables the Government to press the industry harder on domestic contracts. Hence the active efforts of the UK Government overseas, through DESO and defence attaches, to push sales; and the relaxed Government attitude towards bribery in such contracts. As far as we know, this is the only UK industry to 'benefit' from such Government engagement in this way.
35. The defence industry has consolidated since the fall of the Berlin Wall in 1990, with BAES absorbing other industry players in the UK. BAE and Marconi were for long the main UK defence companies and seen as aggressive competitors by the rest of the industry. Marconi was notorious in the industry for bribe behaviour before it was acquired by BAE.
36. The defence industry in the UK and elsewhere bears some resemblance to a feudal structure: there are a small number of prime contractors worldwide, with many, many layers of subcontractors underneath that. It means that the competition to win the prime contracts are intense, and, once won, the work won often lasts for many decades for both the prime and its many subcontractors. Such a structure can lead to arrogance on the part of the prime contractor.
37. The sub contractors are thus very respectful of the primes. It is easy to dismiss a subcontractor if they misbehave or fall out of line. To ask a subcontractor to pay bribes on behalf of the prime has been a common practice internationally, and is portrayed to us by old industry hands as one of the ways to get around the FCPA legislation.

## SECTION 5

### **BAES current implementation practice**

38. This section covers our response to two of the areas of interest to your Committee:

- Reviewing BAES existing ethical policies and practices and comparing these with best practice in similar organisations; (includes business conduct generally, internal control procedures, record-keeping procedures). And,
- Assessment of BAES current implementation of those ethical policies and processes, including its adherence to anti-corruption obligations in practice; and also how that implementation is monitored, to ensure that its internal systems are robust enough to prevent or detect violations

39. Although it is hard from the outside to know what happens inside a company, there is clearly positive change underway at BAES:

- There has been considerable effort over the last three years in rolling out a compliance training programme across the organisation
- We have noticed the changes in the composition of the BAES Board
- We have noticed public reports of the reductions in the number of marketing advisers and other intermediaries being employed
- We note the new requirement for six monthly sign off by Business Heads of the Operational Framework, including adherence to the ethical principles
- We are heartened by the appointment of your Committee.

40. BAES has also been engaging with non-government actors in a way that is a break with the past. For example, they have been engaging directly with Transparency International since 2004, and with the Investment Company 'Foreign and Colonial' in asking them to contribute to BAES' Corporate report.

41. We welcome the commitment of BAES to publish your report and to act upon the findings. We hope that this will include a response outlining the changes that they plan to make as a consequence. We suggest that your Committee re-convene in twelve months time to conclude on the implementations of the Company's proposals.

We have categorised our contributions into what we see as the key areas.

#### ***Leadership***

42. As one leading industry insider said to us recently 'It's not processes, training, procedures that matter – you need all these, but plenty of companies have ticked every compliance and governance box yet have had bad anti-bribery practices regardless; think of Enron, World Com and so forth; within the industry, just think of the case of Boeing and Tanker Leasing. It is strong top management commitment and their leadership actions that really do build credibility with staff, regulators and the industry". Examples of this would be:

- Firing senior executives whose subordinates were bribing, even where the executives were unaware of this, eg General Electric;
- Going to the authorities with suspected cases, eg IBM in Argentina, ABB in the USA;
- Whistle blowing on price fixing cartels, eg ABB in Europe with switchgear.

43. In our view, the core leadership issue at BAES has been one of credibility. We speak regularly to defence company senior officials, Defence Ministry procurement personnel in some dozen countries. Despite the CEO's announcements and statements in the annual reports, very few people, including almost everyone we speak to, believe that the company's senior executives really mean what they profess. They are deeply doubtful that there is anything that will change at BAES, and that the starting point needs to be a change of senior management.

44. At least until recently, the evidence of this includes the following:

- A minimalist public communication policy for years, denying any wrongdoing; such brief flat denials serve only to raise suspicions
- The refusal of the company to say anything about prior suspected cases, including the Czech Republic, South Africa, and Romania. A good anti-bribery company would be pro-actively carrying out a full internal investigation, firing the senior executives responsible, and probably turning the investigation results over to the authorities
- On talking to former company insiders who are close to commercial responsibilities, we understand that it is the same as at a number of other companies: there are strong policy statements from the top, but Commercial Directors and operating units nonetheless have had substantial freedom to act to win the deal
- The 'saga' of the Export Credit Guarantee Department of the DTI seeking to strengthen their anti-bribery requirements in 2005. The industry response led by BAES, was aggressive, and was very quickly successful in forcing a backtracking by ECGD over their proposal. For example, they were against any material disclosure of agents, even confidentially to ECGD, and many other details of very mainstream elements of an anti-bribery proposal
- The Al Yamamah saga has continued for decades, the Company has continued to be being totally reticent on the subject
- Numerous other press articles, for example of moving all their confidential files to Switzerland once the anti-corruption laws were passed in this country in 2002 and the use of at least one offshore trust which has never been disclosed in public company accounts.
- In many professional conferences over the last few years, e.g. on FCPA or on corporate conduct standards, the BAES presentations are widely seen as poor, uninformative and defensive.

45. At its heart is the observation that senior executives at BAES really do not believe there is anything to answer for: that BAES has no need to investigate areas of concern, that these concerns are all underhand attacks dreamed up by the media, particularly the

Guardian. Change will not be effective at BAES unless this core culture of its senior executives is addressed.

**46.** We are aware that there are changes to the composition of the BAES Board and we very much hope that these are a major step in the right direction. But this is unlikely to be sufficient. **We suggest BAES consider a programme of work across the senior levels of the organisation to shift the culture of the organisation. Your Committee will be taking submissions from others on the ways in which a culture can be shifted across an organisation. We make the following specific suggestions for your consideration:**

- **Incorporate business conduct practice as a major component of the leadership development programmes that BAES will have for its senior executives**
- **Establish a community of the top 100 or so BAES executives and use this community as the leading force behind a business conduct and leadership behaviour programme for senior executives. This community may well exist already, in which case the work of that community could be adapted to fit this activity (Para 46)**

47. We believe that something similar to the current trauma being experienced by Siemens could happen at BAES unless significant action is taken. Siemens ticked most of the boxes for a compliance programme. Both the Chairman of the Board and the CEO strongly denied any wrongdoing before the scandal broke. Once it broke, they argued that anti-bribery was neither of their responsibilities. Both have now gone. The head of the compliance programme was sacked for incompetence. The Company's reputation is shattered, and fines in the \$1-2 billion range are likely. There may be useful lessons that your Committee and BAES can extract from conversations with those leading the current reforms at Siemens.

### **Governance**

48. We welcome the greater clarity being introduced on the role of the Board at BAES, as published on the BAES website. We also welcome the recent changes in the composition of the BAES Board.

49. We do not know whether the Board and its sub-committees are taking a more active interest in anti-bribery and corruption risks. It may well be that this is happening and that nothing is visible externally. But the public face has for so long been one of 'no comment no wrongdoing' that the presumption will continue to be that there are no such internal high level processes. There is an immense amount that the Audit Committee can do both to assure the Company and its shareholders that no bribery is taking place, and to show in a more limited form externally that the Company is taking these responsibilities seriously.

50. The Audit committee or CSR committee should regularly review anti-corruption practice; the external Auditors should report to them on the wider brief as outlined above. The

annual anti-corruption report should be open for public information and at a minimum, open to the authorities.

**51. We suggest the following ways to strengthen governance:**

- **One of the Board members of the audit committee should have the specific responsibility for overseeing the risk of bribery and corruption**
- **Make clear the importance of business conduct for the next 5 years or so by making it a fixed 50% of the agenda of the Audit Committee, or relevant Board Committee. Whichever Committee it is, it should contain both outsiders and the external auditors**
- **Similarly, make business conduct monitoring a significant percentage of the internal audit programme.**
- **Strengthen the compliance function within the operating units with both staff and an external consultant, so that it is capable of an extended role in monitoring compliance and following up allegations.**
- **Strengthen the central compliance function. It is widely perceived externally as being weak and defensive. A strong, respected head of compliance should be recruited/appointed, with a personal responsibility to pursue compliance. Consider making the Head of this group responsible to the Audit Committee only, reporting regularly on status (Para 51).**

***Compliance and training programme***

52. We do not have a detailed understanding of BAES' compliance programme and associated training programme. We have requested it specifically so as to be able to pass comment on it for your Committee, but BAES refused to release it to us.

53. Many of our colleagues in the TI movement across Europe have heard officials from BAES' compliance function speak at conferences and workshops. We have sought their views, and the reaction is typified by the following: 'It was striking at the FCPA compliance conference at the Tower Hilton in June that BAES was in a different league so far as compliance was concerned. Companies like Lockheed, Thales, etc have robust and well-resourced executives reporting directly to the Board or the Supervisory Board. BAES' man is a beleaguered individual with no such authority or reporting lines'.

54. BAES state in their corporate report that their programme is in line with that from Transparency International. To our knowledge, ***BAES has not confirmed their compliance with the TI Business Principles with Transparency International and we are inclined to doubt it.*** The TI Business Principles for Countering Bribery cover not only the elements of a policy, but are also backed up with a detailed implementation guide, including training, monitoring, sanctions systems and changes to personnel policies. The BPCB include guidance materials, the 'Six Step' implementation guide and a self-evaluation tool. **We suggest that BAES do a detailed review of how their programme aligns with the TI principles and detailed guidance and engage with the private Sector Programme at TI in reviewing the resulting report together.**

55. Despite this refusal, we generally hear from other European defence companies that the BAES programme is reasonable by European defence company standards. Based on what we know, we have contributions to strengthen it as follows:

***Code of conduct and ethical policy***

56. The Business Principles for Countering Bribery provides the platform for our comments regarding BAES' ethical policy, and there does not appear to be a Code of Conduct. Such a code would be normal in all large companies. There are instead five ethical principles on the website. These are acceptable as principles, but they do not necessarily translate into reality in the form of the underlying processes, training, monitoring and investigations.

***Internal control and Record keeping***

57. Implementation programmes are ineffective unless a Board, or Committee of the Board, that is largely or wholly independent of the executives, monitors them actively at the top of the company. That Board should receive all evidence of suspected cases; and demand that there be full internal investigations into all those that seem to have some substance. We do not believe that this is the case at BAES. It has a Corporate Responsibility Committee, but we are not aware that the Company demands such reports or that it receives them. We have offered to engage with the Chairman of this Committee but this offer has been declined.

58. Internal monitoring and follow up is one of the acid tests of a business conduct policy. The industry is full of examples and stories of companies that 'tick every box' for compliance and training but which are well known to be ready to bribe to secure the business. We have no insight on what BAES is doing internally in this respect. Given all the stories in the press, and feedback to us from industry insiders, the external perception is that this has been a box ticking exercise at BAES.

59. We do see positive and welcome signs of change. In particular, we welcome the new widespread training programme underway, and the new approach requiring sign off by subsidiaries and operating units of compliance with the Company's ethical policies. We have no knowledge of whether this process is operated 'seriously' or not.

60. We have no insight into the internal control processes other than what is stated on the BAES website. Besides the points already made above, one major area of assurance ought to be the internal audit programme, corporately and in each operating unit. To what extent the audit programme is geared towards business conduct violation, improper gaining of business, use of agents, etc is unclear. **We suggest that:**

- **Questions regarding corruption and bribery should form a significant part of the audit programme of the Company at both corporate and operating unit levels.**

- **The audit committee should periodically ask the external auditors to review the quality of these internal audits, to assure themselves that the internal audits are operating effectively, with access to the right people and documents. Para (60)**

61. Regarding record keeping, we have received many comments from people in the industry and those retired from it that the sensitive areas of commercial practice in defence companies such as BAES are kept very tightly controlled and that there are more ways of hiding funds than most firms of accountants are ever going to find. However, we have not sought to substantiate such comments – it is not the policy of TI to investigate specific allegations and claims. **We suggest that:**

- **BAES should consider using their external auditors to routinely review all new contracts for payments to agents and intermediaries**
- **BAES should consider using their external auditors to report annually on all payments to all agents and intermediaries, including their contracts and payments, and report regularly on this to the audit committee.**
- **BAES should consider following up the six monthly sign offs by Business Heads with sample audits that review whether the sign-offs were complete.**
- **BAES should consider periodically (e.g. annually) reviewing all possible ethical policy violations to examine the performance of senior responsible staff in those cases. To discipline them, not just the individual directly implicated, as appropriate. (Para 61)**

### ***Integrity through the supply chain***

62. The defence industry has a deep structure of contractors working beneath the prime contractor. Wrong doing by these subcontractors is a well known area for non compliance, whether with the knowledge of the prime contractor or not. Good companies, for example in the oil and extractive industries as well as in US defence companies, have moved forward a lot in this area, pushing down their business conduct standards to the sub contractors and insisting that the subcontractors do the same beneath them. It is hard and tedious to put this sort of cascade into place. **We suggest that:**

- **BAES should consider starting a rigorous programme to cascade its requirements into its many subcontractors. This would include, inter alia, sign off by the subcontractors, requirements for audits by the sub contractors and on the subcontractors, whistle blowing facilities so that the sub contractor staff can phone the BAES hotline directly, and training programmes comparable to the BAES ones (Para 62)**

### ***Joint ventures, consortia and industry collaborations***

63. Joint ventures are comparable to sub contractors: often an area for wrongdoing out of the eye of the prime contractor.

64. We believe that good standards require that BAES does not enter into any joint venture unless a common set of anti-bribery and related standards are adopted. That the adopted standards should be the higher of the two venture partners, and auditing should be to the same level of intensity as the parent companies. **We suggest that:**

- **BAES should consider establishing a rigorous process through which all joint ventures have to have standards that are equivalent to or higher than BAES' own business conduct standards, and that these arrangements are subject to the same level of audit oversight as mainstream BAES units. (Para 64)**

#### ***Use of agents, consultants and intermediaries***

65. This is one of the critical, defence specific areas where a strong policy is required and where there is great scope to show leadership across the industry. It is a problem that has frustrated purchasing governments, who see agents in place over decades in a particular region, influencing contracts across neighbouring countries. Even where they have been banned, problems of their use have not gone away, e.g. in India.

66. BAES makes extensive use of them. To the best of our knowledge, the Company still supports the confidentiality of these agents and resists disclosure of their use. This is an area where there is scope to improve the way that the Company uses agents and, in areas such as disclosure, to lead the industry. **We suggest that:**

- **BAES should change its policy in relation to the use of agents and advisers. Inter alia, to consider the following:**
  - i. Conduct face to face due diligence with all agents and intermediaries by a qualified lawyer to defined minimum standards**
  - ii. BAES should require all due diligence on agents around the world to be done by a central due diligence unit**
  - iii. Specify a demanding frequency of repeat face to face due diligence, for example at least every two years**
  - iv. Reduce the total number of agents and intermediaries**
  - v. Standardise the nature of the contract that the company has with the agent, and to standardise the terms of payment and to subject the contract to regular review (Para 66).**
- **BAES should disclose the details of the agent's identity and basis of engagement to any purchasing government and to their associated oversight organisations. (Para 66)**

67. The record keeping on the use of agents is a messy area. It is often the case that payments are kept secret even within the company.

- **We believe a high integrity company will be conducting periodic reviews of all payments across the company to agents and intermediaries, and we**

**recommend that the overall record of such payments should be disclosed to the audit committee. (Para 67)**

### ***Export Credit Guarantees***

68. BAES was in the forefront of the industry response to resisting ECGD's higher proposed standards in relation to bribery. The position of BAES did a lot to undermine credibility of its anti-bribery principles. **We suggest that:**

- **BAES should consider taking a different approach to its engagement with the Export Credit Guarantee Department on the questions relating to agents. It would be a good example if BAES were voluntarily to exceed the current standards, for example by voluntarily disclosing to ECGD all use of agents and consultants. (Para 68)**

### ***Investigations into possible and actual violations***

69. Whilst we have no Company specific information, the impression is strongly given, by outsiders and those in the Company, that detailed internal investigations are not undertaken on suspected cases of bribery. We do not know if such investigations, if completed, are passed to the audit committee, as we believe they should. There is no evidence outside the Company of whether its monitoring programme has any teeth.

70. In each operating unit, **we recommend that:**

- **The CEO should have a nominated responsible director for anti-corruption observance. Besides the normal responsibilities, he/she should operate the process required to support the six monthly sign off. He/she should have a dotted line reporting chain direct to the audit committee (Para 70). We suggest that the senior individual be the Finance Director or the Commercial Director.**
- **There should be an experienced compliance officer in every operating unit**

71. **We also suggest the following:**

- **BAES should consider adopting a policy of being pro-active in this area, and being ready to disclose its findings to authorities, as apart of its commitment to high integrity.**
- **BAES should adopt a policy of 'zero tolerance' within each of the subsidiaries. For example, through the firing of senior officials in divisions with a problem, regardless of whether the senior individual had any knowledge of the event. We have passed to your committee and explanation of how this policy operates at GE.**
- **BAES should change to its policy in respect of the investigation of allegations and suspicious circumstances. Report all suspicious circumstances to the**

**Audit Committee; be proactive in carrying out such investigations. Give the audit committee the power to call for all such investigations as it sees fit.**

- **BAES should change the policy of not reporting the results of such investigations to the national authorities to one of disclosure unless there are overriding reasons not to. The audit committee should formally sign off all the latter decisions. (Para 71)**

### ***Transparency in the industry***

72. The industry and its companies will always be the object of suspicion whilst its contracts are so hidden in secrecy. This is changing on both sides. For example, US companies are open about who their agents are. Governments are realising that greater effectiveness/efficiency lies in greater transparency – for example in Europe with the creation of the web based listing of all major defence contracts, and in developing countries like Colombia who publish the details of contracts and tenders. **We suggest that BAES position itself as a leader in the European industry by proposing to governments that tender documents (including price, programme, specification, contractors, sub contractors, agents, JV Partners) be published on the web. (Para 72)**

73. Transparency International has been working with defence companies and governments to promote a transparency tool for major defence contracts. This tool, called the 'Defence Integrity Pact' is a contract between all the bidders for a contract and the purchasing government. The Pact provides for more disclosure, establishes independent oversight, and contains a sanction that will exclude a company from bidding if it contravened the Pact. Importing governments like it because it helps for a more level playing field during the competition. Several of the major defence companies, though not BAES, have been assisting us in developing this methodology. **We suggest that BAES take an industry leading position by actively supporting the use of Defence Integrity Pacts in international contracts. (Para 73)**

### ***'Revolving doors'***

74. There is a long tradition of executives moving from Government into BAES and vice versa, either on secondment or after retirement. There is a high volume of this 'traffic': in 2006, 21 former MOD staff applied for permission to work for BAES: all were granted permission. Subject to an enforced suitable 'gardening leave' period, there is obvious merit in such exchanges. However, as part of a programme to show unambiguously to the public and across government that BAES is changing, **we suggest BAES and the government consider suspending exchanges, secondment and recruiting of each others' officials for a period of, say, five years. (Para 74)**

### ***Offsets***

75. Offsets are a curious and rather hidden feature of defence business. They are a form of barter, whereby the seller agrees to provide extra services to the purchasing

government over and above the weapons sale itself. These extra services are large – often to over 100% of the value of the weapons contract. Offsets are poorly controlled and almost unregulated. They are a major corruption risk. They are not much liked by defence officials either. For example, from the European Defence Agency (EDA) Jan 2006; ‘There should not be offsets in EU procurement’. Ulf Hammarstrom, EDA Director of Industry and Marketing to Defence Conference, Brussels. Quoted in Jane’s 43(10) March 8, 2006

We have no reason to think that BAES is any better or worse than other companies in respect of offsets. However, it is an area where there is immense opportunity to take a lead across the industry in pushing for much tighter control and oversight of them. This is an area where BAES could really make a difference.

The specific corruption risks are the following:

- Offsets are subject to much less study, and scrutiny, than the main contract
- Their influence in the evaluation of the bidders is often completely unclear, and confuses the value for money choice
- Offsets offer huge scope to reward intermediaries anonymously
- Specific offset deals are not settled until long after the contract is signed, and when there is thus much less scrutiny
- Offsets are usually badly monitored
- Auditing and VFM on offsets is almost never done

**We suggest that BAES take a clear and strong industry leading stance to tighten up control and oversight over offsets.**

## SECTION 6

### Collated recommendations

#### 6.1 Broader Government context

We recommend that the following be considered:

- The UK Government set up a group to review the way in which Government and the Company interact, with a view to putting straight some of the peculiar governance arrangements of the past, thereby strengthening transparency,
- The UK Government commissions work to develop a model government contract for government-to-government arms sales. This work could benefit from the experience of the US Government with 'Foreign Military Sales' contracts.
- The UK Government considers ways to strengthen oversight of, and confidence in, the recently signed contract with Saudi Arabia. One way to do this would be to establish an independent oversight commission, composed of two well reputed institutions, enhanced by independent oversight, in the UK and in Saudi Arabia
- The UK Government finds some way to enable a full enquiry be undertaken of the Al Yamamah contract (Para 25)

#### 6.2 BAES current implementation practice

##### *Leadership*

We suggest BAES consider a programme of work across the senior levels of the organisation to shift the culture of the organisation. Your Committee will be taking submissions from others on the ways in which a culture can be shifted across an organisation. We make the following specific suggestions for your consideration:

- Incorporate business conduct practice as a major component of the leadership development programmes that BAES will have for its senior executives
- Establish a community of the top 100 or so BAES executives and use this community as the leading force behind a business conduct and leadership behaviour programme for senior executives. This community may well exist already, in which case the work of that community could be adapted to fit this activity (Para 46)

##### *Governance*

We suggest the following ways to strengthen governance:

- One of the Board members of the audit committee should have the specific responsibility for overseeing the risk of bribery and corruption
- Make clear the importance of business conduct for the next 5 years or so by making it a fixed 50% of the agenda of the Audit Committee, or relevant Board Committee. Whichever Committee it is, it should contain both outsiders and the external auditors
- Similarly, make business conduct monitoring a significant percentage of the internal audit programme.

- Strengthen the compliance function within the operating units with both staff and an external consultant, so that it is capable of an extended role in monitoring compliance and following up allegations.
- Strengthen the central compliance function. It is widely perceived externally as being weak and defensive. A strong, respected head of compliance should be recruited/appointed, with a personal responsibility to pursue compliance. Consider making the Head of this group responsible to the Audit Committee only, reporting regularly on status
- (Para 51)

### ***Compliance and training programme***

- We suggest that BAES do a detailed review of how their programme aligns with the TI principles and detailed guidance and engage with the private Sector Programme at TI in reviewing the resulting report together (Para 54)
- We suggest that Questions regarding corruption and bribery should form a significant part of the audit programme of the Company at both corporate and operating unit levels.
- The audit committee should periodically ask the external auditors to review the quality of these internal audits, to assure themselves that the internal audits are operating effectively, with access to the right people and documents. Para (60)
- We suggest that BAES should consider using their external auditors to routinely review all new contracts for payments to agents and intermediaries
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- There should be an experienced compliance officer in every operating unit (70)

We also suggest the following:

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### ***Offsets***

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## **APPENDIX**

Proposal for creating a global defence industry anti-corruption consortium (Transparency International)  
November 2005