FTI Consulting Risk Research Project

What Companies Do Right (and Wrong) in Emerging Markets
Executive Summary

Large North American and European-based companies for decades have made significant investments in emerging markets to manufacture, distribute, and sell their products and services. Indeed, foreign direct investment (“FDI”) inflows lately have increased across the board in developed, developing and transitional economies, reflecting a slow but steady recovery from the Great Recession of 2009. And, in fact, FDI flows to developing economies reached a new high in 2013 of $576 billion according to the United Nations Conference on Trade and Development. Given the intense and growing interest in doing business in emerging markets, FTI Consulting’s 2015 Risk Research Project focuses on the risks businesses and investors face in these markets and discusses how leading companies work to mitigate such threats.

The importance of risk awareness and mitigation in developing economies cannot be overstated. Emerging markets, for the first time, accounted for almost half of the $1.46 trillion in global FDI in 2013, the most recent year for which data are available. Representing an enormous pool of untapped resources — both material and human — emerging markets offer equally large opportunities for growth. At the same time, the losses companies have incurred in these markets continue to grow even as the International Monetary Fund (“IMF”) reported in 2013 that, for many reasons, its regulatory frameworks have become increasingly stringent over the last decade — a trend FTI Consulting sees everywhere, thus creating new risks and magnifying old ones. Consequently, our research began by surveying 150 business leaders of North American- and European-based multinationals with operations in emerging markets countries, specifically those executives involved in risk and compliance. These executives answered 32 questions that enabled us to categorize the most significant risks their company and investors face in those markets and to quantify the impact. We then spoke with both practitioners (guaranteeing them anonymity so they could speak freely while not exposing their enterprise to any possible reputational harm) and FTI Consulting experts to learn where companies go wrong in dealing with these risks and to identify what the best companies do to mitigate such threats. (For a fuller explication of our survey and methodology, see the demographics and charts on pages 19 and 20.)

Our results indicate that most multinational companies have suffered significant losses in emerging markets, stung by three major categories of risk: regulatory, bribery and fraud, and reputational issues. The most damaging and costly incidents occur when two or more of these risks converge, creating a cascade of losses that become increasingly hard for companies to contain or stem.

These three risks are connected and could be considered three faces of the same beast. For example, a company could violate a regulation (either intentionally, due to weak compliance policies, or inadvertently, due to changing, abstruse or hard-to-follow rules), then bribe an official either to reduce a fine or make it go away. If the malfeasance becomes public, the company will find itself in hot water — its reputation damaged. That will make it more difficult to do business, impair future revenue potential and, perhaps, lead the enterprise to cut corners in compliance, thereby fueling a vicious cycle of crime and punishment as the company blunders from one public relations disaster to another.

According to our research, the organizations that have suffered most frequently and have experienced the greatest losses have tended (among other practices) to maintain an arm’s-length relationship with their projects and subsidiaries in these markets, underinvesting in or insufficiently focusing on local managerial resources and compliance training. Conversely, enterprises that have suffered the least have one thing in common: They play by the rules, both local and international, and, thereby, furiously guard their reputation. They make compliance a strategic priority at the highest corporate levels and provide the resources to execute on the ground. These companies do not go along to get along. They combine a deep understanding of the political and business cultures of the environments in which they operate with a stout refusal to cut corners. These companies develop response plans to deal with incidents before they arise, and these plans are continuously updated and aggressively communicated both internally and externally. In this way, when any one of these three risks emerges, it can be isolated so as not to produce the perfect storm of converging issues that multiply losses and impair a hard-to-restore corporate reputation.
## 10 Key Findings

1. Eighty-three percent of multinational companies have suffered significant losses in emerging markets since 2010.

2. The average cost per incident has been estimated at $325 million.

3. The average cost per company over the last five years has been $1.38 billion.

4. The average loss per year was $260 million, or 0.7 percent of annual revenues.

5. In 99 percent of all incidents that involved a loss, the cause was either a regulatory, a bribery or fraud, or a reputational issue.

6. For the worst incidents reported, 60 percent involved more than one type of hazard (35 percent involved two, and 25 percent involved all three).

7. In other words, the very worst incidents with the highest losses involved two or three of these types of risk converging.

8. None of these types of issue is any less pernicious than the others, although:

   - **Regulatory issues** are the most frequent cause of loss.
   - **Bribery and fraud issues** are the most expensive.
   - **Reputational issues** often make a bad situation worse.

9. The best companies protect themselves in three major ways that others do not. (We define leaders as companies whose self-reported losses from these incidents as a percentage of revenues was in the lowest quartile, averaging 0.2 percent; laggards are in the highest quartile with a loss rate averaging 2.2 percent of revenues.) Leaders:

   - **Maintain a consistently good reputation over the long haul:**
     - i) Leaders rate the value of maintaining a good reputation 10 times higher than laggards.
     - ii) Leaders rate the importance of taking a long-term view of their investment in emerging markets more highly than laggards by a ratio of more than 2:1.

   - **Take great care to accommodate and influence the local regulatory environment:**
     - i) Leading companies believe it is more important to their success to avoid doing business in places where compliance may not be possible than do laggards by a ratio of more than 5:1.
     - ii) Leading companies believe it is critical to invest in helping construct a suitable regulatory framework than laggards by a ratio of almost 3:1.

   - **Meld corporate ethical standards with local culture:**
     - i) Leaders rate conducting a continuous dialogue with staff on compliance issues higher than laggards by a ratio of almost 7:1.
     - ii) Leaders rate the importance of implementing compliance policies that are suitable to the jurisdiction in which they are doing business more highly than laggards by a ratio of more than 2:1.

10. **Leaders maintain vigilance against all three types of risk.** That helps companies avoid getting caught by any one type of risk and enables them to prevent any single incident from generating others and magnifying losses.
Report

After the Great Recession of 2009, many companies expanded their investments in emerging markets such as China, India, Russia, Eastern Europe and Latin America, looking for the growth opportunities that organizations no longer could find at home. (According to projections from the IMF, emerging markets economies grew 5.1 percent in 2014, more than double the combined 2 percent rate of established economies.) But those growth opportunities came with a cartload of risk.

A Dangerous Troika of Pitfalls: Regulatory, Bribery and Fraud, Reputational

An overwhelming majority of the companies surveyed for this report — 83 percent — have suffered major incidents in emerging markets since 2010. The average number of loss-making events experienced by each responding company from 2010 through 2014 was four (just under one a year), and the average loss per company was $1.38 billion over that time. The average loss was $260 million a year, or 0.7 percent of average annual revenues, with the average incident’s cost estimated to be $325 million.

The seriousness of this pervasive problem need not be further emphasized nor the need to remedy it.

In 99 percent of all cases that involved a loss, the cause devolved from bribery and fraud (the latter included a variety of malfeasance such as money laundering and intentional accounting misrepresentations), regulatory violations (both intentional and inadvertent due to host country regulations that are byzantine or that change so frequently as to be hard to keep up with) or reputational issues. The very worst incidents, however, involved two or three of these issues occurring either together or in quick succession. When asked about the monetary damage from their worst regulatory, bribery and fraud, and/or reputational incident since 2010, three respondents indicated their losses totaled $1 billion or more. Four said losses were between $500 million and $1 billion, and 13 percent said losses were between $100 million and $500 million. Nearly half (47 percent) said their single biggest losses were between $10 million and $100 million. Most important, for the worst incidents reported (the top third of each company’s single biggest), 60 percent involved more than one type of hazard; 35 percent involved two, and 25 percent involved all three.

In other words, when either regulatory, bribery and fraud or reputational issues converge, any incident is almost guaranteed to take its place among a company’s most damaging and costly events.

Respondents cited regulatory issues as the most frequent cause of loss-generating incidents, followed by bribery and fraud and then reputational issues, as seen in Figure 1.

The specific causes of loss, ranked in Figure 2 by frequency, ranged from local regulatory change through delivery of substandard products and services. The single most common cause of loss-making incidents is changes in host country regulations, followed by anti-competitive behavior by the host country.

Some of these incidents such as regulatory change originate externally (in yellow) and some, for example bribery, internally (in orange).

Figure 1: The Dangerous Troika

<table>
<thead>
<tr>
<th>Distribution of loss-making incidents by type</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bribery/Fraud</td>
</tr>
<tr>
<td>Reputational issues</td>
</tr>
<tr>
<td>Regulatory issues</td>
</tr>
</tbody>
</table>

Regulatory Risk

As we saw in Figure 1, regulatory hazards (44 percent) are the most frequent cause of outcomes that negatively affect companies. As seen in Figure 3, the negative impacts of regulatory issues primarily include loss of revenues and reputational harm.

It is worth noting that the major impacts of running afoul of regulations while operating in a developing economy, as noted by our respondents, are not companies or their leaders landing in court. Instead, respondents cited loss of revenues and reputational harm far more frequently than criminal prosecution of companies or their officers and fines.

Complying with regulations in developing economies is particularly difficult. As a
South American-based director of a large multinational chemical company pointed out, "The regulatory rules get changed so often, it’s hard to know what they are, let alone follow them."

One of the major reasons for this regulatory uncertainty can be laid at the doorstep of the political instability that tends to be endemic in emerging economies. A large U.S. energy company’s representative in Eastern Europe noted that whenever a new government comes in, "it wants to change the rules," which puts "the earlier agreements in financial difficulty.

"Officials are still learning that this is not how things are done in developed countries," he said.

John Corbett, a company director with experience in multinational food companies and a Managing Director at FTI Consulting, said, "Political upheaval can make a country too dangerous for investors. New regimes, or differences in opinions among government agencies, can undo an agreement or call a lease or title to land into question." Corbett pointed to one multinational agricultural company that responded to the recent political uncertainty in Ukraine — and also to what he called its "ambiguous local laws" — by declining to invest despite the area’s extraordinarily rich agricultural potential.

Regulatory uncertainty can prevail in developing economies even without the drama of regime change or the obvious external political threats and internal instability that presently afflict Ukraine. Government officials even in relatively stable countries can change regulatory processes and control how rules and regulations are interpreted. These situations can occur quite quickly, often with disastrous consequences for companies and investors. This particularly is common when overseas

Figure 2: Where the Losses Come From
Distribution of causes of loss-making incidents

<table>
<thead>
<tr>
<th>Cause</th>
<th>External Causes</th>
<th>Internal Causes</th>
</tr>
</thead>
<tbody>
<tr>
<td>Regulatory change</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Anti-competitive behavior by host country</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Bribery</td>
<td></td>
<td></td>
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<tr>
<td>Price fixing</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Allowing harmful work practices</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Conflict between home and host countries</td>
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<td></td>
</tr>
<tr>
<td>Data breach</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Damaging the environment</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Collusion between JV partner and host country</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Accounting fraud</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Taking excessive profits</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Posing a national security risk (to a foreign country in which you operate)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Delivering substandard products or services</td>
<td></td>
<td></td>
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</tbody>
</table>

Frequency cited
companies are involved in joint ventures with state-owned enterprises or with companies that have strong social or political connections to the host state.

For example, in April 2012, Argentina seized control of YPF — an Argentine energy company originally established as a state-owned enterprise, then was privatized and acquired by Spanish energy firm Repsol. As justification, the Argentine government charged Repsol with a variety of regulatory violations and financial and accounting irregularities — throwing the book at the company and offering zero pesos to compensate Repsol for its loss. (In 2014, Argentina agreed to pay Repsol $5 billion in bonds as compensation, less than half the company’s initial demand.)

In another unhappy brush with a state-involved enterprise, in 2010 Churchill Mining, a London-based resources company, thought it had found a rich source of coal in Borneo. Churchill invested more than $40 million surveying its find, and the company’s share price soared in anticipation. Then a local official revoked Churchill’s license to mine the coal, charging that the company had violated environmental regulations by illegally clearing land in a government-protected forest.

What had happened? The rules had changed. Previously, only the central government in Jakarta had the authority to revoke a mining license; now a local authority could — and did. Churchill’s share price plunged 85 percent from its 2010 high, and the dispute continues to wind its slow way through the World Bank’s International Centre for Settlement of Investment Disputes. (In 2014, Churchill filed a claim for $1.3 billion in damages.)

A particular area in which it often is difficult for companies to stay compliant with regulations in emerging economies is keeping up with tax law. For example, each of Brazil’s 27 states has its own rules regarding what’s taxed and how much “and the rules change all the time,” said Renato Niemeyer, Chief of Tax Legislation in Roraima State, Brazil. According to Niemeyer, this has led more than one multinational company to postpone paying taxes, as “the penalties [for postponement] are relatively low, and on-time payment is expensive due to the complexity.”

One problem with this strategy, he said, is that when a company does pay the penalties, “corrupt officials will solicit the organization for bribes in order to lessen the penalties or to change tax legislation to benefit the company.” In this way, organizations are tempted to participate in a corrupt system, leading them down the slippery slope to those two other risks of the dangerous troika: bribery and fraud and reputational damage. Furthermore, avoiding or postponing taxes by paying off officials simply doesn’t work — at least not for long.

“When companies deal with one politician, that person soon may be gone, to be replaced by another who will demand new arrangements, new bribes, and the cycle of corruption is perpetuated,” Niemeyer averred.

Another regulatory area that is increasingly problematic for companies — especially in the energy, mining and construction sectors — is environmental. Local politicians can curry favor with local populations, which frequently bear the brunt of mining operations, by bringing actions against multinationals under a broad array of environmental regulations and difficult-to-meet environmental impact mitigation agreements. The poster child for this situation is Chevron v. Ecuador, a long-running battle over liability for environmental damage arising out of Amazonian oil production. The enormous resources that have been poured into this dispute underline the importance of establishing and attending to the concerns of local populations when companies begin operating in citizens’ backyards.

“Latin America is growing very green in its politics as a result of the global commodities boom,” said Camilo Granada, Senior Managing Director and Latin American Head of the Strategic Communications segment at FTI.
Consulting. Therefore, big companies are under strict scrutiny both from government agencies and non-governmental organizations regarding compliance with environmental and social regulations.

“Companies must fully embrace their role in helping the local community in order to protect and enhance an organization’s reputation,” Granada pointed out.

**What lagging companies do wrong**

According to Jose Pineiro, a Madrid-based Managing Director in the Forensic & Litigation Consulting Practice at FTI Consulting, globalized companies operating in widely varying regulatory environments increasingly “overestimate their internal expertise to analyze overseas risk. They are not objective about their own capabilities. And, sometimes, business agendas overstep compliance protocols.”

Perhaps most important, many companies are unwilling to walk away from jurisdictions where compliance with regulations simply may not be possible (see Figure 4), which leading companies are willing to do. As FTI Consulting Senior Managing Director in the Forensic & Litigation Consulting segment Eduardo Sampaio said, “Companies are too hungry to make deals in hyped environments; therefore, they’re closing deals without an adequate understanding of what they’re getting into.”

**What leading companies do right**

As regulatory issues are the single biggest cause of business losses (see Figure 1), it is impossible to overstate the importance of learning to address these issues proactively. In our survey, we separated the quartile with the lowest self-reported losses as a percentage of revenues (the leaders) from the quartile with the highest (the laggards). As seen in Figure 4, leading companies believe it is more important to their success to avoid doing business in places where compliance may not be possible than laggards do by a ratio of more than 5:1 and in the importance of engagement (i.e., investing in helping construct a suitable regulatory framework) by a ratio of almost 3:1. As John Klick, Global Leader of FTI Consulting’s Economic Consulting segment observed, “Successful companies put a lot of effort into helping host countries establish economically rational regulatory environments — which benefit both investors and the host country over the long run — and in maintaining the stability of those regulatory environments as companies are buffeted by the inevitable winds of political change.”

Companies that do well in heading off regulatory headaches also study their host country’s regulatory framework before initiating investments and projects and structure them to accommodate the prevailing regulations.

Citing another multinational agricultural company, Corbett said the organization has an investment filter to make sure it understands the commercial structure.

### Figure 4: Just Say No

<table>
<thead>
<tr>
<th>Relative Importance of Regulatory Risk Mitigation Measures, Leaders vs. Laggards</th>
</tr>
</thead>
<tbody>
<tr>
<td>Don’t do business in places where compliance may not be possible</td>
</tr>
<tr>
<td>Invest in helping construct a suitable regulatory framework</td>
</tr>
<tr>
<td>Structure investments to accommodate prevailing regulations</td>
</tr>
<tr>
<td>Understand the political connections of people we might do business with</td>
</tr>
<tr>
<td>Scrutinize the regulatory framework beforehand</td>
</tr>
<tr>
<td>Understand the political climate between our home and an emerging market country</td>
</tr>
</tbody>
</table>

*Relative Importance, Leaders vs. Laggards*
and the sensitivities of local jurisdictions, thereby safeguarding the organization’s investments. For example, the company realized that due to regulations, it could not easily invest directly in sugar farming in Brazil so it is moving to invest in a sugar mill instead. This was, said Corbett, a good way to provide “a backup sugar supply for the company’s home country and avoid political and legal challenges.”

Corbett also said a company always must be prepared to walk away from any venture in a country where the political system is unstable; i.e., where compliance may not be possible, as reflected in the earlier example of a company’s willingness to abandon Ukraine despite the abundance of fertile farmland.

Large companies seem less vulnerable to regulatory issues, perhaps as a function of having greater resources to monitor and analyze regulatory changes but, possibly more important, because large companies are more likely than small companies to be able to influence regulatory processes in the countries in which they operate.

A large energy company’s Eastern European representative said his company deals with the inevitable regulatory changes in emerging markets by including a stability clause in contracts that can protect the organization from legal or fiscal changes that could negatively affect its future income. “And if new taxes threaten the economics of our project, the company re-works the governing contract to make sure we are compensated in another way,” he said.

He also said his company continuously monitors “proposed new laws, governmental changes and taxes that could affect the company” and proactively engages with government leaders. “We explain [to the government] how any new regulations will impact us as an industry or company and, in turn, emphasize how that affects the country’s well-being.”

Of course, the energy company, by virtue of its size, will be listened to more closely than many smaller companies. However, the South American chemical company director cautioned that dealing with politicians in emerging economies, while necessary, requires patience and planning no matter how large the company or how powerful its presumptive clout. Politicians in these jurisdictions, he said, rarely have a clear understanding of the economics of large corporations so “there’s a lot of business education you’ll have to provide, and you need to find out who will be receptive to it.

“The latter,” he said, “by far is the largest issue. … But the best way to deal with the risks is by talking.”

This is a sentiment and strategy endorsed by a former president of an international energy company’s upstream subsidiary who has worked in a number of countries with emerging and developing economies. He said it’s critical to “establish teams that can work with the indigenous people and local councils,” especially those people who might oppose a project.

Joseph Kalt, the Ford Foundation Professor (Emeritus) of International Political Economy at the John F. Kennedy School of Government at Harvard University and a Senior Economist with FTI Consulting subsidiary Compass Lexecon, noted that “when regulations are constructed on the basis of sound economics and in concert with cultural norms of the host community, a solid foundation is created for a long-term business relationship between the investor and the host country. If either of these components is shortchanged, business risk and political risk increase exponentially.”

### Bribery and Fraud

In addition to loss of revenues (mentioned by more than half of respondents), companies that have been found to have engaged in fraud, or paid bribes, open themselves to a host of negative impacts. The most frequently cited consequence by respondents is reputational harm (67 percent), followed by loss of revenues (56 percent) and then prosecution of the company (44 percent) (see Figure 6).

In most developed markets, paying bribes either to win or to facilitate business has been long understood to be bad business, and a host of international laws such as the U.S. Foreign Corrupt Practices Act (“FCPA”) and the UK Bribery Act leave no doubt that paying bribes is regarded institutionally and legally as far outside the pale of accepted or acceptable practice. However, in many developing economies, bribery simply is a way of life, a business facilitator that’s not even thought of as corrupt. Multinational corporations operating in these markets often find themselves between a rock and a hard place: Refuse to pay bribes and see your business suffer or fail; pay bribes and accept the numerous risks listed in Figure 6. And when dealing with state-owned enterprises (frequently characteristic of developing economies), the distinction between countries’ political and business elites effectively is erased, putting overseas investors in perpetual jeopardy of crossing the line into bribery activities they may not even know exist.
A regional audit director of a U.S.-headquartered international supplier of gases and chemicals for industrial uses noted that in China, facilitation payments are customary to keep projects on target. However the long-established Chinese custom of gifting customers — including cash vouchers for mooncakes, a traditional treat that now, in their most elaborate and expensive forms, has become almost synonymous with graft — violates both the FCPA and the Bribery Act.

Facilitation payments are common in most emerging markets, and it is hard for local managers to avoid paying them. “For example, if an employee in distribution is due to make a delivery and the truck gets stopped because it’s overweight, the company may need to pay a fee to get the truck through,” described the audit director, continuing: “Another example is when people meet with police authorities about a situation, it’s customary to leave packs of cigarettes behind after the meeting.” This is part of China’s business and political culture, but China is trying to change as its own anti-bribery laws become stricter. (In September 2014, as part of an anti-corruption initiative, the Chinese government set up a website where the public could report mooncake abuse.)

“If China wants to continue growing and being competitive,” the audit director said, “it can’t afford to have too many people lining their pockets.

I hope this will get better, but I’m not sure it’s going to happen very quickly.” And, for businesses, the chances of getting caught engaging in bribery skyrocket when the businessperson soliciting or receiving the bribe is politically connected.

The most dramatic example of China’s changing attitude toward bribery, and one of the most egregious cases of a company participating in large-scale bribery to facilitate business, was a recent case involving a multinational pharmaceutical company. In June 2013, Chinese police raided the company’s Asian headquarters, seizing documents. Eventually, the company was charged with, and admitted to, bribing hundreds of doctors to prescribe its drugs, reaping over a hundred million dollars in illegal profit. In September 2014, after having been found guilty, the company was fined almost a half a billion dollars, and several of its overseas executives were convicted and deported.

The former president of an international energy company’s downstream subsidiary said his company employs internal and external intelligence teams to investigate proposed business partners. Its external teams include former members of Scotland Yard. The reports these teams produce not only tell much about the presumptive partners but also about their backers — “the real players behind the curtain,” he said.

Ted Unton, a former Director, Global Financial Compliance at Bemis Company, a U.S. global manufacturer of flexible packing products and pressure-sensitive materials, said his company has hired private investigators to look into alleged improprieties at partner companies and by partner executives. He suggested that companies make sure that all bidding processes in which their subsidiaries or partners engage be rigorously competitive and open in order to mitigate against the tendency in emerging markets to steer business to family members.

But hewing to the straight and narrow, avoiding even the appearance of corporate misbehavior, rarely is simple. According to the Eastern European energy company’s representative, bribery is a major element of Eastern European economies. Companies, he said, must pay to win government contracts, and offering thank you gifts for receiving favorable government rulings is common. These payments are a revenue generator for governments in general and for individual officials in particular. “Some government officials will look for opportunities to fine a company, then ask for a bribe to make the fine go away,” he said. The problem is most acute at the lower levels of government, where poorly paid officials always are on the lookout for ways to generate extra cash.

For multinationals, the risk of becoming complicit in this sort of business is magnified when a company is working...
with and through local subcontractors who know no other way of doing business and often have powerful, if unacknowledged, political allies. “Multinationals have numerous partners,” pointed out Panama-based Matias Mora, Senior Managing Director of the FTI Consulting Forensic & Litigation Consulting segment. If a multinational’s joint venture partner in a developing economy gets into trouble in its home country, he said, this will have a direct impact on the multinational itself. The FCPA and UK Bribery laws explicitly hold companies accountable for their partners’ and customers’ actions no matter how remote from an organization’s core operations. From real estate transactions at the parent company’s expense. Having side businesses is not that unusual in Asia, and what Western companies consider conflicts of interest are bound to crop up.

“Local partners in some countries can be corrupt,” noted Corbett, describing a company that invested hundreds of millions to acquire a majority stake in an Indian agricultural company. Despite the due diligence the acquirer conducted, it became clear that the Indian company had undertaken a massive fraud, basically “cooking its books.” India’s relatively “ lax accounting and tax standards” made this possible, Corbett said.

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And, Mora said, multinationals increasingly are reliant on joint ventures rather than wholly owned subsidiaries. This creates a roster of new risks for running afoul of anti-bribery and corruption laws as “ now you’re dependent upon a separate entity operating in an unfamiliar jurisdiction with unfamiliar rules and a different business culture.” As FTI Consulting’s Pineiro said, “Companies are exposed when doing business in jurisdictions outside their home country. This risk is increased due to globalization, as well as a new digital environment in which information becomes public almost at the same time as a given situation evolves.”

Even when a subsidiary is wholly owned, it can be difficult to guard against bribery and fraud from a distance. Companies, understanding that it’s important to have native-born managers deal with local suppliers and customers, sometimes put too much trust in those managers. In one case that engaged FTI Consulting’s Global Risk & Investigations Practice, the general manager of a wholly owned manufacturing subsidiary in China was found to be operating a side business, bribing local officials and profiting from real estate transactions at the parent company’s expense. Having side businesses is not that unusual in Asia, and what Western companies consider conflicts of interest are bound to crop up.

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As the engine of globalization picks up speed, countries increasingly are entering into regulatory pacts with each other to facilitate cross-border investigations. For example, one German multinational engineering and electronics firm was investigated by the European Union for price fixing. Consequently, according to FTI Consulting’s Sampaio, the company now is facing sanctions in Brazil, which, to attract inward FDI, is attempting to bring its own business practices more in line with Europe’s.

Globalization, which once promised to unite the world with standardized business practices, spreading the rule of law everywhere, now seems to be an engine churning out ever-multiplying risks.

**What lagging companies do wrong**

The key to avoiding getting ensnared in the coils of bribery and fraud in emerging markets is to implement a culture of compliance, establishing (and sticking to) policies that are tailored to the local culture. And, of course, it requires conducting careful due diligence when partnering with third parties or hiring employees to staff subsidiaries.

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The key to avoiding getting ensnared in the coils of bribery and fraud in emerging markets is to implement a culture of compliance, establishing (and sticking to) policies that are tailored to the local culture. And, of course, it requires conducting careful due diligence when partnering with third parties or hiring employees to staff subsidiaries.

As the engine of globalization picks up speed, countries increasingly are entering into regulatory pacts with each other to facilitate cross-border investigations. For example, one German multinational engineering and electronics firm was investigated by the European Union for price fixing. Consequently, according to FTI Consulting’s Sampaio, the company now is facing sanctions in Brazil, which, to attract inward FDI, is attempting to bring its own business practices more in line with Europe’s.

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Too many times, Pineiro said, compliance teams mostly are situated in a company’s home country headquarters or in a nearby (and reliably more comfortable) location. For example, said Pineiro, imagine that a bank has large operations in Uruguay, but its compliance team is in the United States or the UK or Spain, with just a few compliance officers in Uruguay. Risk, he says, “comes where the money is. You have to put resources in compliance where you’re doing business.”

That lack or misallocation of resources extends to information technology (IT). Financial statement fraud and fraudulent accounting practices are encouraged, Pineiro says, by IT systems that “are too disparate, making it difficult to reconcile accounts in different jurisdictions, forcing companies to rely on manual, error-prone processes for review and reporting.” And, said Granada, “lack of IT integration in reporting financials can invite fraud,” as can an inadequate amount of investment in compliance training.

Large companies, in which governance is more complex, appear increasingly vulnerable to activities perpetrated by individuals (bribery) and conspirators (price fixing, accounting fraud, excessive profit taking). But perhaps the biggest mistake lagging companies make is not playing by the rules in the first place and paying that first bribe.

**What leading companies do right**

When Arvind [his first name] was engaged as Managing Director for a global leader in consumer and durable appliances to lead the company’s re-entry into the Indian market, he encountered a culture that paid “speed money” to do business and make payments to inspectors “who always would find problems in routine operations and ask for small amounts ranging from $20 to $100 to ignore them.” Arvind refused to pay even those small amounts. He went, he said, to the most
senior official in the government’s Inspection Department and told him the company is a “global leader that is good for India and is committed to ethical business.” The inspector also was assured that Arvind had the backing of the company’s leadership.

While making these calls had a negative impact on the company’s short-term results, once Arvind and the company took that position, he said “the inspectors stopped coming.”

As Arvind said, the most important thing a company can do to avoid getting enmeshed in a corrupt business environment is to “get the right managers on the ground who have impeccable track records of integrity and values and then empower them. Make sure they are senior so they can’t be held hostage by a mid-level, in-country proxy and unable to stand up to local authorities. Otherwise, they could end up paying bribes or participating in other corrupt behaviors.”

The type of dialogue Arvind engaged in both with officials and with his own staff to drive home the value of playing by the rules is accounted by leaders as the second most important factor in mitigating emerging markets risks by a ratio of nearly 7:1, as seen in Figure 8.

Arvind emphasized the importance of having support for insisting upon compliance from the top levels of the corporation but also the necessity for having the right people on the ground so that policies are ingrained in the culture of the company. Leaders rate the value of that local focus more than twice as highly as do laggards. As FTI Consulting’s Hallahan said, top-down compliance training that lacks empathy for local realities generally does not work.

Niemeyer said companies that succeed in Brazil “build strict control systems for internal employees and outside entities” such as resellers, distributors, customers, third-party service providers and so on. In Brazil, he said enforcing good governance practices with subsidiaries and third parties is the only way to avoid corruption, and these practices should include the consistent auditing of processes relating to invoicing and payment, human resources and outsourced contracts.

Niemeyer went on to stress the importance of having nationals leading or co-leading subsidiaries. Issues in Brazil are “quite complex to foreigners,” he said, “who are used to more organized and controlled environments with clearer and more stable rules and strict controls and penalties over corruption.” Arvind, an Indian national, concurred.

The Eastern European energy company representative said his company’s contracts with suppliers include two pages dealing with anti-corruption, anti-bribery and anti-competitive practices. All the company’s contractors, he said, are trained in how to detect a corruption case and what to do about it. A key element in the training, he said, is instructions
always to inform the company’s leaders whenever a bribe is offered.

Unton said Bemis has “elaborate signoff systems to help local operating managers stay aware of compliance issues. The company mandates quarterly questionnaires and check offs.”

**Leaders rate the value of that local focus more than twice as highly as do laggards.**

And, said Unton, compliance directors “need to have the support of the CEO and board of directors. I used to meet quarterly with our CEO and Chief Financial Officer and with the Audit Committee of the Board of Directors. I never had to call the CEO on an issue, but people knew I could, and that is essential.”

Unton pointed out that headquarters has the ultimate responsibility for compliance (it certainly is responsible to the U.S. Securities and Exchange Commission, for instance) but, he said, echoing Arvind’s sentiment, “You have to have people on the ground you can trust.” As FTI Consulting’s Sampaio said, leading companies “think globally, but they act locally.”

The international energy company’s former downstream subsidiary president emphasized internal controls that zero in on compliance and ethics, saying his company places almost as much importance on these as it does on operational safety, which, of course, must be a primary concern for energy producers.

It is worth noting that a strong compliance posture need not necessitate an army of compliance officers. One person — if it is the right person — with the proper support at headquarters can be enough.

### Reputational Issues

Reputation is a delicate thing. Once upon a time, the Florida aquatic theme park SeaWorld was associated with happy children watching seals perform tricks. Today, thanks in large part to the 2013 documentary “Blackfish,” it conjures up images of tortured sea mammals. (SeaWorld disputes the film’s allegations of animal mistreatment.) Since the film’s release, SeaWorld’s stock has plunged, last summer, attendance was down, and earnings have suffered.

SeaWorld had been having secular financial issues before “Blackfish” blackened the park’s reputation (theme park attendance has been suffering for years), but reputational issues, when they arise, always make a bad situation worse.

As seen in Figure 9, reputational issues most often lead to loss of revenues (as has been the case with SeaWorld) and exclusion from markets.

The list of giant companies that have had their reputation attacked in emerging markets is a long and varied one. A few notable incidents include a global retailer (accused of engaging in bribery in Central America); a government-owned oil company (accused of being involved in bribery in South America); and a global food service retailer (accused of using tainted meat in and violating a variety of safety regulations in Asia.)

In South America, one of Europe’s largest engineering companies which had over a billion dollars in infrastructure projects contracted, was banned from bidding on any new contracts. The ban stemmed from the company’s involvement in a price-fixing cartel. And even though the company self-reported the bribery attempt and since has taken an aggressive stance against corruption, the country, acutely sensitive to its national image and its ability to attract foreign investment, felt compelled to distance itself from the engineering firm.

Journalists, said Niemeyer, increasingly are investigating and reporting happily on corrupt business practices, raising the reputational risk for companies that do not play by the rules.

Even companies that always play by the rules — corporations that work to avoid even the whiff of scandal — can suffer reputational damage from events beyond their control. In China, said the audit director, building new plants often requires the payment of multiple fees to partner company agents. These rich emoluments can make a company look bad to the local population. The energy company’s representative in Eastern Europe pointed to the catastrophic accidents that, by the nature of its operations, plague the energy sector and, thereby, can damage any energy company’s reputation.

It is worth noting that a strong compliance posture need not necessitate an army of compliance officers.

Large corporations make inviting targets. The South American chemical company director said people in his region believe (and the press reinforces the idea) that companies like his are raking in massive profits. “We don’t have a lot of defenders,” he said.

**What lagging companies do wrong**

“When companies attempt to do business overseas, they essentially become political, as well as economic, actors,” explained FTI Consulting Strategic Communications segment Senior Managing Director Jackson Dunn. “The company’s investment inevitably affects the local economy, and that has spillover effects in the political community. This places companies at reputational risk, which they frequently fail to understand or acknowledge.”

This especially is true for U.S. companies in emerging markets. In Dunn’s view, these companies fail to appreciate
that their host country may not view them simply as businesses conducting business (as they view themselves) but as “an extension of the U.S. government,” and, therefore, companies underestimate the impact local politics can have on their ability to execute.

Dunn stressed that businesses need to understand the importance of the role they play in the domestic social, economic and political life of the countries in which they operate. Furthermore, organizations should understand the impact their actions can have on their international reputation. Failing to fully appreciate this can lead to a slow corporate response when incidents occur.

The longer it takes for a company to respond to an event, the greater the potential for damage to its reputation. And a slow response time, said FTI Consulting’s Sampaio, generally is due “to a lack of local capabilities.”

As was the case with regulatory and bribery and fraud issues, a lack of investment in the local market — in this case in communications capabilities — can spell trouble down the road.

Of course, some companies do not play by the rules. They take the easy way. One bank official told us his firm “goes through the [compliance] motions,” but he believes there is no way to “stop illegal activities from happening.” He said his bank is too big, and there are too many employees to vet; penalties levied on the bank are viewed as merely a cost of doing business. Indeed, as we saw in Figure 5, large companies are more prone to bribery and fraud than small companies: A larger workforce and a broader operational scope provide greater opportunities for the commission of illegal activities with a concomitant rise in the difficulty of reining them in. An executive at another large multinational admitted that his company, on occasion, does make facilitation payments. Top management is “uncomfortable” about it but feels it has “no choice.”

However, once a company strays from the straight and narrow and once it’s caught engaging in bribery or committing fraud or violating local regulations, reputational damage will start to mount, and, at that point, harm can only be limited, not avoided. And, in some cases, the effects can linger for a long, long time.

**What leading companies do right**

“If you comply,” said Arvind, “there is no reputational risk.”

This may sound simplistic, but it is a sentiment echoed by almost all the executives of leading companies with whom FTI Consulting spoke. Playing by the rules is the absolute best way to reduce reputational risk, as well as the two other members of the dangerous risk troika. This takes effort, money and attention, but going the extra mile — especially when it comes to tailoring policies to local conditions — can help companies safeguard their reputation, sometimes against all odds.

When one foreign agricultural investor first set up operations in Australia, for example, locals were suspicious of its capital — it did not come from a traditional North American or European jurisdiction. Attacks came from adjoining landowners, local businesses and politicians and were fueled by the press. The company responded by making sure that local suppliers would not be cut out of its agricultural business even though by sourcing materials locally rather than nationally, the company sacrificed certain economies of scale.

Corbett said the foreign investment entity always asks itself what it has to do to keep the local community strong. “The risk as a multinational corporation is that you come in and negotiate and cut out the local community,” he said. “You’re the biggest game in town, so not including locals has a massive impact.

“We build an enterprise structure that ensures the company engages with the local community even when negotiating national deals, guaranteeing throughput and margin for local suppliers,” Corbett explained. “We showed government a clear strategy that emphasized community engagement and commitment to local businesses and employment.” The result was that foreign
investment participation in the Australian economy was seen as a plus, not as a negative, and that built trust and helped guard the company from reputational harm. In two to three months, the company had won its critics over.

According to the South American multinational chemical company director, it’s his company’s reputation that guards it against future reputational damage (that is, maintaining a consistently good reputation), which, in effect, helps the company from breaking its own rules and provides it a certain latitude in the court of public opinion. “In terms of business, our company has been in the region for 60 years and is well-known,” he said. “It is very clear that we are not going to pay [an illegal] penny for anything.”

The energy company’s Eastern European representative’s description of how his company maintains its reputation echoed the chemical company director’s. The energy company executive insisted that companies that wish to mitigate reputational risk should abjure all forms of corruption or sketchy business, saying it’s critical that this commitment be communicated to the top officials in the jurisdiction in which the company is operating. As soon as a company begins doing business in a country, “let them know you will walk away if this [corruption] happens,” he said. “In contracts with small contractors, specify that they are legally responsible for following anti-corruption laws.”

In other words, the energy company trains all its contractors, no matter how small, in compliance. And as an example of his company’s zero-tolerance policy on bribery, he recalled that in Russia, the company had problems with some employees who were not able to get work permits without paying someone off at the foreign embassy. “We refused,” he said, “and took the case directly to the Ministry of the Exterior at the highest levels. The next day, we were granted the visas, legitimately, without paying anyone.”

“‘We don’t pay anyone,’” he insisted.

Added the former president of the energy company’s downstream subsidiary, “You need to do due diligence on who you’re getting into bed with,” underlining the point that in emerging markets, trouble that can negatively affect a company’s reputation is more likely to come from third parties — partners and contractors — than from decision makers at headquarters.

Corbett said the foreign investment entity always asks itself what it has to do to keep the local community strong.

Leading companies believe that a good reputation is its own reward, paying dividends over the long term. As we see in Figure 10, leaders believe by an
extraordinary 10:1 ratio that maintaining a consistently good reputation is critical to mitigating reputational losses.

Maintaining that reputation is difficult since local populations in many locations (as we've seen in this report) are suspicious of the motives and actions of multinationals. It takes time and what leaders define as a “long-term investment perspective” (which they rate as important at more than twice the rate of laggards) to allay those suspicions. However, it can be done.

For example, the former president of the energy company subsidiary recalled how his company had to buy land for a 40-mile pipeline in Bangladesh. The area’s wealthy landowners were willing to sell the land to the company, but many farmers worked that land and depended upon it for income. The energy company, by kicking them off, certainly (and justifiably) would have been fitted for a black hat. Instead, the company set up five offices along the pipeline route to help locals find alternatives to farming. Because the company went the extra mile and demonstrated its concern for the people in the community in which it operated, the locals began to accept the plan. Promised protests were canceled, and, later, many of the same farmers ended up with new (and better) jobs on the pipeline and in the company’s plants. The company, instead of feeding mistrust, developed a cadre of supporters that the former president believes will stand it in good stead in the future.

Corbett emphasized that “community engagement is vitally important for foreign capital,” and the greater the engagement, the less room the mythology about the evils of foreign investment has to take hold.

Our leaders advise that over the long haul, maintaining a good reputation includes communicating with the media in a thoughtful, strategic fashion. However, the South American chemical company director acknowledged that managing the media and media relations is a 24/7 job. Each statement by the company needs to be examined “a trillion times” prior to release, he said, because he knows that everything his company says will be placed under the high-powered microscope of media and public scrutiny. Corbett agreed that there are huge returns to be reaped by making sure that “both the locals and the press understand the benefits your investment will bring.”

Said FTI Consulting’s Granada, “As governments seek to stamp out corruption, both transparency and ethics become increasingly important,” especially with the rise of social media and the growing interest of traditional media in ethical matters. It, therefore, is not only critical for corporations to comply “but to communicate their compliance and ethics policies openly,” Granada said.

FTI Consulting’s Dunn says that the stronger a company’s reputation, the more confidence it can inspire at all levels of government and the easier it will be for the company to build productive relationships at the top. That trust is best realized, Dunn said, if a company has knowledgeable people on the ground who can address issues of concern — regulatory, bribery and fraud, and reputational — diplomatically.

How Leaders Differ from Laggards

Companies that are best at containing their incidents and limiting their losses aren’t just different from laggards in what these leaders do; they are different from them in how they think about emerging markets risk.

As we see in Figure 11, leading companies that have been able to contain their losses rank almost every best practice for the mitigation of regulatory, bribery and fraud, and reputational risk higher than do laggards. This is doubly impressive (or head scratching) when one considers that laggards already have experienced more losses than leaders have but still don’t rate these precautions as highly. Indeed, when asked how well laggards thought they managed risk, companies with higher losses generally thought they managed risk about as well as their low-loss peers. In other words, laggards don’t seem to know they are more exposed.

It makes one wonder.

It also is worth noting that laggards believe running “pre-emptive publicity campaigns to counteract negative reactions” is a good strategy. Laggards apparently have an outsized belief in the power of public relations to ward off risk, absent doing anything else. Leaders do not. They believe in the power of action, as in conducting a continuous dialogue with local staff on compliance issues (65 percent of leaders do this as opposed to only 10 percent of laggards). This spread is one of the largest differences we’ve found, along with leaders being reluctant to do business in places where compliance may not be possible (almost 30 percent compared with 5 percent) and maintaining a consistently good reputation, which half of leaders consider important as opposed to only about 5 percent of laggards.

As we have seen, the best companies protect themselves in three important ways:

They maintain a consistently good reputation over the long haul. They do this by playing by the rules and letting the leadership of the country in which they are operating know that this is what they are going to do. They also conduct due diligence on partners that can ruin their reputation, as well as their balance sheet. And they maintain their reputation by working with and through the media before their reputation has been placed at risk.

They take great care to understand and accommodate the regulatory environment. They do this by scrutinizing the regulatory framework of the country in which they are considering investing, and they do so before they make their investment. They devote time and energy to trying to help the host country understand whatever difficulties are inherent in the prevailing regulatory framework, engaging consistently with regulators and viewing this involvement as a long-term commitment to the country. And if that regulatory framework
Figure 11: Leaders Take Risk Seriously
Relative importance of risk management tactics - Leaders vs. Laggards

- Have compliance policies suitable for the territory
- Conduct continuous dialog with local staff on compliance issues
- Train in-country expats and locals in fraud and compliance
- Scrutinize the regulatory framework beforehand
- Have a long-term investment perspective
- Maintain a consistently good reputation
- Understand the political climate between our home and an emerging market country
- Retain substantial compliance resources “in-country”
- Understand the political connections of people we might do business with
- Invest at our own cost in improving local infrastructure to improve goodwill in an emerging market country
- Structure investments to accommodate prevailing regulations
- Perform exceptional due diligence on potential joint venture partners and senior employees
- Invest in helping construct a suitable regulatory framework
- Don’t do business in places where compliance may not be possible
- Run preemptive publicity campaigns to counteract negative reactions

Low rate of loss  High rate of loss

is constructed so as to make compliance impossible, leading companies are willing to walk away.

They engage with the local culture. Leaders have employees and managers on the ground that they can trust in the countries in which they do business, and they engage in a continuous dialogue on compliance issues with local staff. They are thorough in their compliance training and processes, often putting native-born managers in place who have served elsewhere in the company and have absorbed the company’s culture of ethical business practice. And top management impresses upon middle management that the company is committed to rigorous, unbending compliance and will act accordingly.

Laggards, however, are more likely to fall back on two provably unproductive practices: trying to understand the political winds blowing between the home and host countries and running advance publicity campaigns. Public relations can be effective but never without the supporting action that will give it weight and reality. Without that, public relations rings hollow and eventually (and ironically) can contribute to the reputational damage it was meant to prevent.
The Benefits of Doing It Well

The benefits of getting good at managing the three risks identified in this report are manifest. The difference in rate of loss as a percentage of revenues ranges from 2.2 percent for the laggards to 0.2 percent for the leaders.

As well as being better equipped to profit from the vast opportunities present in emerging markets economies, there is a lot of money to be saved by improving the ways companies manage the risks that come with operating in these geographies. To derive actionable intelligence from the qualitative understanding of these risks is a multidisciplinary exercise," says Arun Shukla, Senior Managing Director in FTI Consulting’s Corporate Finance practice and principle inventor of the Geomarket Risk Model ™. “It requires conversion of qualitative assessments of the geopolitical risks into quantitative scores which can be input into a model that includes traditional corporate finance adjustments to the weighted average cost of capital. This approach lets you improve the risk/return profile of an overall portfolio.

And clearly, it does not pay to be a laggard.
Research Process and Demographics

FTI Consulting conducted this research in November and December of 2014. We wanted to explore the experiences in emerging markets countries of large (at least $1 billion in annual revenues) North American- and European-based multinationals across industries since 2010 regarding regulatory, bribery and fraud, and reputational risk.

The Process

More specifically, we wanted answers to questions such as:

- Which of regulatory, legal (bribery and fraud) or reputational risks were more common?
- What types of risk lead to larger losses?
- How much money have companies lost from incidents in emerging markets countries over the last five years?
- Did the losses from incidents increase when all three risks were involved in the same incident?
- What risk management practices were most effective in mitigating these risks?

We designed a survey questionnaire with 32 questions. A large research panel company, Research Now, fielded the survey to its database of executives and managers who work for North American- and European-based multinationals with operations in emerging markets countries. Research Now screened out thousands of respondents for the following reasons: a) their company had less than $1 billion in revenues; b) their company was not headquartered in North America or Europe; c) they said they did not have considerable knowledge about their company’s investments since 2010 in emerging markets.

In all, 150 executives whose screening questions qualified them to take the survey filled out the 32 questions. (The participants were assured total anonymity, and Research Now withheld their identities.)

To gather qualitative data on the topic, our research partner Bloom Group conducted phone interviews of 45 to 60 minutes in length with 10 executives at large North American and European multinational companies. Bloom Group worked from an interview guide. The identities of these individuals and their companies, too, have been kept anonymous unless they specifically granted permission for their name and comments to be included in this report. FTI Consulting also collected voluminous secondary research, looking for reliable and reputable published articles and studies that reported on the regulatory, legal and reputational problems challenging large Western multinational companies in emerging markets countries.

Survey Demographics

The 150 survey participants had the following characteristics:

By geography, 54 percent were based in North America and 46 percent in Europe.

By industry, the largest sectors were high tech (17 percent), industrial manufacturing (11 percent), banking/financial services (10 percent), engineering and construction (7 percent), telecommunications (7 percent) and life sciences (6 percent).

By company size, average revenues were $41 billion; median revenues were $5 billion. Some 17 percent were between $1 billion and $5 billion; 7 percent were between $5 billion and $10 billion; 13 percent were $10 billion to $20 billion; 30 percent were $20 billion to $50 billion; 18 percent were $50 billion to $100 billion; and 15 percent were $100 billion or more.

By function, 29 percent were in strategic planning/corporate development; 19 percent were in finance; 16 percent were in operations; 5 percent were in compliance; 8 percent were in legal; 4 percent were in audit; 5 percent were in risk management; 7 percent were in marketing or sales; and 7 percent were in other functions.

By level in organization, 55 percent were heads of business functions or business units; 45 percent were direct reports to such first-level executives.
Industry Distribution

- High-tech (hardware)
- Industrial manufacturing
- Other
- Banking/financial services
- Telecommunications
- Engineering and construction
- Life sciences (pharmaceuticals)
- Retail
- Automotive
- Consumer packed goods
- Energy (oil or gas exploration)
- Aerospace/defense
- Travel/hospitality/transportation
- Minerals and mining
- Utilities (electric, water, etc.)
- Insurance

Proportion of respondents

Headquarter Locations by Country

- 52% USA
- 12% Germany
- 13% Canada
- 8% France
- 13% United Kingdom
- 2% Other European country

Company Size Distribution (USD Billions)

- 17% $1B - $5B
- 13% $10B - $20B
- 7% $30B - $40B
- 9% $50B - $70B
- 9% $100B - $10B
- 15% Other

Distribution of Respondents between HQ and Emerging Market, by HQ Country

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<th>Country</th>
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Proportion of respondents

Distribution of Functions

- 3% Marketing
- 4% Audit
- 4% Sales
- 5% Risk Management
- 5% Compliance
- 7% Other
- 8% Legal
- 16% Operations
- 19% Finance
- 29% Strategic planning/corporate insurance