

Business ethics,
global companies
and the defence
industry

***Ethical business
conduct in
BAE Systems plc
– the way forward***

WOOLF COMMITTEE

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and the defence industry

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May 2008

This Report has been prepared by the Woolf Committee (the Committee), an independent committee appointed by the Board of Directors of BAE Systems plc (the Company) to publicly report upon the Company's ethical policies and processes. It is chaired by the Rt Hon The Lord Woolf of Barnes. The Committee members are Douglas Daft AC, Philippa Foster Back OBE and Sir David Walker. The Secretary to the Committee is Dr Richard Jarvis.

The Committee's Terms of Reference, biographies and information on the approach it has taken are included in Appendices A-D of this Report.

The views and recommendations included in this Report are entirely those of the Committee. It is for the Company and it alone to decide whether, and if so how, to act on this Report.

The Report is not for the purpose of guiding or influencing any investment or other financial decision by any person. Accordingly, it must not be relied upon for that purpose. Any such decision is accordingly the sole responsibility of the person making the decision.

In this respect and generally, the Committee accepts no legal responsibility or liability to any other persons for the contents of, or any omissions from, this Report.

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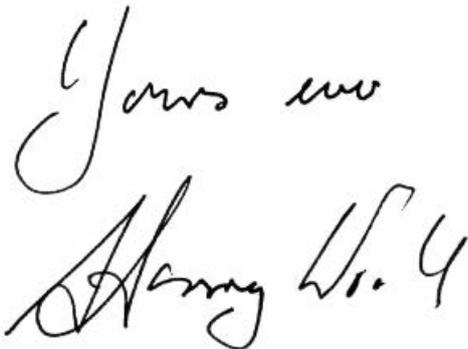
May 2008



The Committee is pleased to present to the Board of Directors its unanimous Report.

We welcomed your commitment, prior to the commencement of this Review, to implement our recommendations in full. In the event we make 23 recommendations. The implementation of these will be a considerable challenge for the Company over the next three years.

We have provided a route map for the Company to establish a global reputation for ethical business conduct that matches its reputation for outstanding technical competence. Taken together, this should ensure the continued long-term success of BAE Systems plc as a major UK-based global manufacturing company.



The Rt Hon The Lord Woolf of Barnes

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SECTION 1

Introduction

Context of the Review

- 1.1 The Terms of Reference of the Woolf Committee¹ (the Committee), set by the Board of BAE Systems plc (the Company), require the Committee to:
 - identify the high ethical standards to which a global company should adhere;
 - identify the extent to which the Company may currently meet these standards; and
 - recommend the action that the Company should take to achieve such standards.
- 1.2 The Board of the Company, prior to the commencement of this Review, undertook to implement the Committee's recommendations in full. This is to our knowledge an unprecedented step for a major company.
- 1.3 BAE Systems plc is a global defence company. Less than a decade ago it did not exist in its present form. The Company was formed in 1999 with the merger between British Aerospace plc and GEC Marconi. It was then primarily a United Kingdom (UK) defence company and strongly dependent on export sales to overseas governments.
- 1.4 Since then the Company has grown through a series of international acquisitions and now has significant operations in the United States of America (US), Sweden, South Africa, Australia and the Kingdom of Saudi Arabia, as well as in the UK. Among the products it manufactures are military aircraft, submarines, warships and land systems. The Company has become a primary supplier of indigenous defence capability to each of these countries and its operations in the US are now on a par with those of the UK. The Company was ranked in 2007 as the third largest defence company in the world by defence revenue. The revenue amounted to over \$25 billion².
- 1.5 A major contributor to the Company's present position were its contracts with the UK Government in support of an agreement made in 1985 between the UK and Saudi Governments and subsequently named the 'Al Yamamah' (AY) programme. The overall value of the AY programme exceeded £43 billion. The contracts played a critical role in establishing the Saudi air defence system. In addition, the contracts helped secure the manufacturing capacity needed to maintain the defences of the UK. The first AY contract was negotiated over 20 years ago and the majority of the contracts under that agreement have now been completed with the remaining aircraft and naval support elements currently being carried out under the December 2005 Saudi British Defence Cooperation Programme. The terms

¹ The Woolf Committee is an independent committee set up by the Board of BAE Systems plc to publicly report upon the Company's ethical policies and processes. The Committee's Terms of Reference are at Appendix A.

² Defense News Top 100, 2007. www.defensenews.com.

of the agreement between the two Governments and the contracts between the Company and the UK Government have not been made public. The two Governments regard the terms of the contracts and what has occurred in their performance as confidential matters involving national security.

- 1.6 Since 2001 the Company has faced increasing criticism of its conduct, primarily relating to AY contracts but also in relation to its activities in other countries, some of which are the subject of ongoing investigations. Widespread adverse media coverage was intensified by the knowledge that investigations were being conducted into the AY contracts from July 2004 by the UK Serious Fraud Office (SFO). On 14 December 2006 the SFO announced it had decided to discontinue its enquiries, on the grounds of public interest relating to issues of national security. The decision was subject to judicial review and on 10 April 2008 the High Court released a Judgment³ that ruled that the decision was unlawful. All this, and the decision in June 2007 of the US Department of Justice (DoJ) to conduct its own investigation into the AY contracts, has resulted in continued criticism and scrutiny of the Company's conduct.
- 1.7 The allegations and the adverse publicity they have attracted has caused and continues to cause significant reputational damage not only to the Company but also to the UK Government. The Company took the position that because of reasons of national security and the ongoing criminal investigations, it was prevented from advancing its explanation for the events that occurred. The Company has always maintained that it does not believe that it has done anything that would constitute a criminal offence and, as Lord Justice Moses made clear in the course of his Judgment on behalf of the Court in the recent judicial review proceeding⁴, there may be reason to doubt whether the allegations in respect of the AY contract could be proved to be true:

"46. The essence of any bribery offence in relation to payments to an agent is the absence of approval by the employer or principal. The need to rebut the defence of consent is a particular difficulty in relation to offences overseas, as the Attorney General pointed out in his evidence to the Constitutional Affairs Committee (Q335, 27 June 2007) and as is noted at paragraph 4.93 in the Law Commission Consultation Paper (No. 185) "Reforming Bribery".

47. According to the Attorney General's evidence, BAE has always contended that any payments it made were approved by the Kingdom of Saudi Arabia. In short they were lawful commissions and not secret payments made without the consent or approval of the principal. The cause of anti-corruption is not served by pursuing investigations which fail to distinguish between a commission and a bribe. It would be unfair to BAE to assume that there was a realistic possibility, let alone a probability, of proving that it was guilty of any criminal offence. It is unfortunate that no time was taken to adopt the suggestion (§ 34) to canvass with leading counsel the Attorney's reservations as to the adequacy of the evidence."

Here the judge was echoing the similar comments made by the then Attorney General, the Rt Hon The Lord Goldsmith QC, in the debate on 14 December 2006 in the House of Lords⁵.

- 1.8 While it is necessary for us to understand the general nature of those allegations, and the impact they have had (and continue to have) on the global reputation of the Company, our task is not to conduct an inquiry into the truth or otherwise of the criticisms made of past conduct. We are concerned with the Company's present activities and, in particular, to ensure that it has the necessary policies and procedures in place to reduce, as far as is practicable, the risk of such allegations being made in the future.

³ *R (Corner House Research and Campaign Against Arms Trade) v The Director the Serious Fraud Office* [2008] EWHC 714 (Admin).

⁴ *Ibid.*

⁵ House of Lords, *Hansard*, 14 December 2006, column 1712.

- 1.9 So, even if the Company's belief is correct, and it has not been guilty of bribery, this does not materially alter our task except in so far as the allegations continue to damage the reputation of the Company. Critically, both the Chairman and Chief Executive, in discussions with us, acknowledge that the Company did not in the past pay sufficient attention to ethical standards and avoid activities that had the potential to give rise to reputational damage. Combined with this was its acceptance of conditions which constrained its ability to explain the full circumstances of its activities. Together, these contributed to the widely-held perceptions that it was involved in inappropriate behaviour. They recognise that, justly or otherwise, these perceptions have damaged the Company's reputation and that it must continue along the route of taking all practicable steps to ensure that such circumstances do not re-occur in relation to future contracts.
- 1.10 In these circumstances the Company has embarked on a programme of change to ensure that its ethical standards matched the highest global standards in the industry. One of the steps it has taken is to set up the Woolf Committee.
- 1.11 The Company is not alone in having to focus on these issues. In recent years Boards and senior management of a number of significant global companies have been distracted by the need to deal with allegations of ethical malpractice. Restoration of a company's reputation, when it is seen to be seriously tarnished, can be a complex and lengthy process involving significant distraction of senior management and often litigation. If reputational issues are not promptly addressed they are likely to fester. This can impact on the development and future profitability of a company. Among other damaging consequences, may be a decline in employee morale and difficulties in recruiting high quality personnel.
- 1.12 The vulnerability of global companies to such pressures has itself increased markedly as their exposure to diverse local business practices has been extended with the growing geographic spread of business. There are also sharply rising expectations from customers, suppliers, governments and wider society that companies will establish clear global standards for their conduct in the market place.

Structure of the Report

- 1.13 The remainder of the Report is structured as follows:
- In Section 2 the standards of ethical business conduct by companies that operate globally are considered. This is because the Company is now a leading global defence company and the expectations and responsibilities for ethical conduct have increased dramatically for global businesses.
 - In Section 3 the characteristics of the defence industry which affect the standards of ethical business conduct to be expected of a global defence company are examined. For this purpose it is necessary to understand the complexities and constraints that usually apply to fulfilling a defence contract. This is necessary to identify the key areas of risk, and to determine whether and how these may be tackled to meet the standards that should be achieved by a global company. Some observations as to the actions global defence companies should take, as well as actions the UK Government could take to support and encourage ethical business conduct in the defence industry, are set out.
 - This provides the context for Section 4, where the Committee sets out its assessment of the ethical policies and procedures of the Company and the way forward in the future. The Committee makes its recommendations to the Board of the Company as to the action it should take in order to achieve a leadership position in standards of ethical business conduct, not just within its industry peers, but among global companies more widely.
 - In the final section the Committee gives its overall assessment and provides a consolidated list of its recommendations and observations.

SECTION 2

Business ethics and global companies: the background

Business ethics and reputation

- 2.1 Concern about the importance of conducting business to high ethical standards is not new and can be traced in UK corporate history to the early 19th Century. From the industrial revolution onwards, company founders whose names are still familiar today drew upon their beliefs and social values to guide their approach to business, especially in relation to their employees (e.g. Cadbury, Rowntree and Unilever). Similar examples can be found in the US and more widely throughout the world. As such businesses continued to prosper over time, it became increasingly recognised that this was because, rather than despite, of their ethical standards. Over the last 30 years business ethics has become an academic discipline of its own and is now increasingly taught in universities and business schools around the globe.
- 2.2 The Institute of Business Ethics (IBE) describes business ethics as the application of ethical values, such as integrity, fairness, respect and openness, to business behaviour¹. Embedding these values in the culture of a company is crucial. Business ethics relates to all the activities of a company, from how it develops, produces and delivers its products and services, to its interactions with its customers, suppliers, employees and wider society. It is not as is sometimes construed, simply in relation to behaviour that might be judged to be corrupt.
- 2.3 The precise nature and significance of ethics in a particular business situation depends on its context and on the impact it is capable of having on a business or businesses. This impact has grown significantly in recent years and as a consequence businesses are, and should be, attaching much greater importance to it.
- 2.4 There are numerous explanations for this development. Business stakeholder groups have higher expectations of how an organisation undertakes its activities. Failing to live-up to these expectations can have an impact on the company's "licence to operate", or the degree of regulation or legislation that might otherwise be introduced to constrain behaviour. Many companies monitor this external view of the business through attempts to manage their reputational risk. The reputation of a company has become of greater importance in the ability to continue to prosper. Even if a company has done nothing to justify an attack on its reputation, a negative perception will itself be seriously damaging over time. The twin forces of globalisation and digitalisation means news (good, bad, true or false) is instantly and widely available. In these circumstances those who are responsible for the running of a business are under greater responsibility, not only to act ethically, but to be seen to be doing so.

¹ Institute of Business Ethics, *Living Up To Our Values* (2006).

- 2.5 Reputation takes a long time to establish or rebuild but can be seriously damaged in a short space of time. It reflects a combination of behaviour (actual or perceived), communications, actions and expectations of a company. It is not static, and is in the eye of the beholder, whether individual or collective. The reputation of a company will influence, possibly in a critical way, how it is perceived by all of those with whom it deals in the conduct of its business. The importance of reputation flows from its influence on current and prospective customers and therefore the company's business prospects; on employees and their morale; on the ability to recruit staff, in particular for senior positions; and in attitudes and the continuing flow of comment in relation to the company in the media, the analyst community and in the capital markets.
- 2.6 In the common law, the concept of the reputation of an individual is well developed. The test often applied to determine whether an individual's reputation has been damaged is whether the alleged behaviour would "lower someone's reputation in the mind of a right thinking person". For a company, its reputation will derive from the quality of the product or service, its financial performance and treatment of staff, its leadership and its stand on the ethical issues it faces. So a company needs to test day-to-day commercial decisions by asking itself "would this action (or inaction) damage the company's reputation in the mind of a right thinking person?" This test is similar to those used commonly for ethical situations: "how would I feel about others knowing of my decision?", or "how would this be reported in tomorrow's newspaper?"
- 2.7 The linking of ethical behaviour to reputation makes the effective management of reputational risk and ethical business conduct an integral part of what drives a company's continuing commercial success. It also allows the following key factors to be accommodated in the framework applied to the management of reputational risk:
- What constitutes acceptable ethical business conduct changes over time and conduct that at one time may not have "damaged the company's reputation in the mind of a right thinking person" could subsequently cause considerable damage.
 - There may not always be a simple right or wrong answer as to the ethical merits of any business decision. There may be reasons for taking or not taking a decision which may impact on the reputation of a company. The position can be further complicated because conduct that might cause reputational damage in one country may not do so in another.
 - Standards of conduct may need to be above that required by law to avoid reputational damage. Failure to comply with the law will always be unethical and damage reputation. But conduct may not be contrary to the law yet still be considered to be unethical and cause damage to a company's reputation. A company's concerns in relation to its reputation should extend beyond those for which it is personally responsible under a legal liability. A company's reputation can be damaged by the actions of third parties such as advisers, suppliers, contractors, and business partners in joint ventures.
 - Ethical business conduct should be integrated into existing decision making policies and processes and into training and audit.
 - Openness and transparency are key elements underpinning ethical business conduct: "If this action or inaction were widely known, would it damage the company's reputation? Can I defend it publicly?"
- 2.8 The range of factors that may impact upon a company's reputation and be covered by the term "unethical business conduct" is broad and challenging. It covers the behaviour of the company

in its relations with employees, customers, shareholders and other investors, suppliers and contractors, governments and local communities, competitors and non-governmental organisations (NGOs).

Responsibilities of global companies

- 2.9 Reputation is important for all companies irrespective of their size or sector. In each case attention must be given to establishing appropriate standards of ethical business conduct and in ensuring that these are applied by all those within and connected to the company. This supports a campaign protecting reputation which is particularly important and challenging for companies that have operations across countries with differing cultures, values and legal regimes.
- 2.10 The rise of the internet and of 24 hour news means that reputationally damaging information can be generated, collected, disseminated, corroborated (or not) and commented upon on a scale and a speed unthinkable as recently as 10 years ago. Pressure groups are now highly skilled at deploying this information so that it will have the maximum impact on a company's reputation. The number and influence of such groups is growing rapidly. Their strategy is changing. They are moving away from their traditional focus on changing national and international governmental policies to achieving the same objective by influencing global companies.
- 2.11 The terms on which global companies achieve their implicit "licence to operate" have therefore altered rapidly in the last decade. The power and influence of global companies has developed in a way that has increasingly outstripped the reach of individual sovereign governments, whose principal capability and competence is to act on a national basis. It follows in this situation that the assumption of substantially greater corporate responsibility for self-regulation should be the necessary accompaniment to the process of globalisation. If global companies are to retain their legitimacy it is necessary for them to respond positively to this responsibility.
- 2.12 Global companies derive their legitimacy from two core factors:
- i. their success in creating economic value; and
 - ii. demonstrating that, in succeeding in their business, they operate to high ethical standards.

Economic success alone is not sufficient to assure such legitimacy. Unless it is complemented by high standards of conduct that command confidence and respect on the part of stakeholders (in the widest sense not just those with a direct stake in the success of the business), a global company is likely to encounter increasing challenge and regulatory intervention. Such challenge and regulation will have the potential for eroding the company's overall economic performance and market valuation over time. In contrast, global companies whose ethical standards and conduct of business are, and are seen to be, at the leading edge, will face reduced public concern and risk of regulatory intervention. Instead they may draw positive benefits from an enhanced reputation.

- 2.13 The clear message for the successful global company is that with power comes responsibility and that the privilege of access to the global market brings with it the responsibility to assume high standards of ethical business conduct. Achieving and being seen to achieve such standards, across many countries with differing cultures and values, is undoubtedly one of the major business challenges of the 21st Century. It is upon the Board of Directors and senior executives of a global company that the principal obligation for meeting this challenge falls. The behaviour of the Board and senior executives must reflect this, collectively and individually. Their behaviour must exemplify and underpin the ethical standards set for the company as a whole.

2.14 Having high standards of ethical business conduct, and demonstrating such standards are being met, is rapidly becoming a requirement for companies in any sector wishing to operate globally. Those at the leading edge will gain competitive advantage, in part from their high reputation. By contrast, those lagging behind will be at risk of sustaining commercial damage and potential regulatory intervention. This is an issue of the utmost importance to Boards of global companies.

Implementation by global companies

2.15 Meeting this challenge raises key specific issues. In order to understand how global companies are addressing these issues, and what may represent good practice, the Committee commissioned the IBE to undertake some benchmarking research². The first phase of this work analysed information published on ethical business conduct by 12 global companies from a number of different sectors based in the UK, US and Continental Europe, including BAE Systems plc. The second phase analysed responses provided in confidence from a selection of six companies from the original sample. Five specific questions were asked concerning the implementation of particular ethical policies, and also how the overall effectiveness of their ethical policies was assessed. A third phase summarised a selection of external, international business ethics standards with particular reference to anti-bribery standards.

2.16 The Committee sponsored a Roundtable Seminar³ for senior representatives from global companies, governments and other interested parties to explore some of the issues raised by the IBE's research. Many of these issues were also addressed separately in meetings with, and in representations to, the Committee as part of its Review⁴. Drawing upon this information, the following sets out some indicators of the minimum level to which a global company should aspire.

Responsibilities of Boards of Directors

2.17 The effective management of reputational risk through achieving high standards of ethical business conduct is at the centre of corporate governance. The individual directors of the Board of a company have responsibility to ensure and assure high standards of ethical business conduct, and are under a statutory duty to do so⁵. To achieve this the Board must not only ensure that ethical conduct and the impact on reputational risk are explicitly taken into account in their own decisions on policy and strategy, but that this is also reflected in decision making throughout the company at all levels and adhered to in the face of financial and operational pressures. This issue should therefore be a regular, if not standing item on the Board's agenda.

2.18 Corporate reputation is a global phenomenon. A company that is, or aspires to be, global, is unlikely to attract respect for, and the ultimate business benefit of, a positive global reputation, unless the associated standards of conduct are observed in every area in which the company operates. A corporate reputation will be fragile unless it is made robust by the continuing proactive commitment of the company's leadership at all levels. The Board must ensure the values, principles and standards of business conduct underpinning how the company operates are established corporately and applied globally. It is not sufficient to establish these country by country, based upon the accepted standards in that particular location.

2.19 The Board should ensure that a senior executive is responsible for the overall programme of implementing these standards across the company. In addition, every senior executive and the heads of

² Information on the three phases of the research by the IBE and its findings are at Appendix F.

³ Details of the Roundtable Seminar, including a list of attendees and a summary of the discussion, are at Appendix H.

⁴ A list of who the Committee met with and from whom submissions were received is at Appendix D.

⁵ Companies Act 2006, ss.171-177, for a list of director duties. Implicit in these duties is a requirement that directors behave with high standards of ethical business conduct. See the Companies Act Explanatory Notes.

business units should be given a personal responsibility for demonstrating high standards of ethical business conduct and for effective implementation in the business. This will be reflected as a factor in their performance appraisal and remuneration. Board members should be exemplars of the standards and receive regular training in business ethics and ensure that all employees do as well.

Specific Board Committee

- 2.20 Given the importance of the issue to effective corporate governance, many companies see the advantage of having a dedicated Board Committee to assist the Board in discharging its responsibilities on ethical business conduct and reputational risk⁶. The name and range of functions for such a Board Committee varies from company to company. For simplicity we will hereafter refer to it as the “Board Committee”. The Board Committee’s role should be to oversee and provide assurance to the Board that its overall policies are implemented and being followed in practice. It should ensure that an effective programme is in place to implement the company’s own corporate standards of ethical business conduct and that those standards, and the policies and procedures to implement them, are kept under regular review. They should ensure areas of potential high reputational risk are identified by the executive and policies and procedures developed to mitigate these risks, and assess reports and oversee follow-up actions following breaches or allegations of breaches of ethical policies and in ethical behaviour.
- 2.21 The Board Committee should perform part of its role in respect to reputational risk in a similar way to that which the Board Audit Committee performs its role in relation to financial risk, providing assurance to the Board that effective policies, procedures and controls are in place and being applied to manage reputational risk and meet the company’s standards of ethical business conduct. The Board Committee will ensure a programme of regular internal and external audit of the management of ethical business conduct is in place, and they will report on the outcome of these regularly to the Board, and publicly in the annual report.

Role of senior executives

- 2.22 Notwithstanding what we have observed about the role of the Board, it is the responsibility of the Chief Executive Officer (CEO) and senior executives to develop and implement procedures and processes to apply in practice the Board’s policy on ethical business conduct, overseen by the Board Committee. “Tone from the top” is an overworked phrase, but fully justified here. Unless the CEO and other senior executives clearly demonstrate their collective commitment and personal adherence to high standards of ethical business conduct, the Board is unlikely to be able to discharge its responsibilities properly and the corporate reputation may suffer.
- 2.23 Senior executives must therefore assume personal responsibility to ensure the effective implementation of high standards of ethical business conduct in the areas of the business for which they are responsible. A key part of this will include setting an example in their own business conduct and in their personal decision making. It will also manifest itself by regular communication internally and externally of the importance to the company that high standards of ethical business conduct are followed, because failure will lead to a loss of corporate reputation. Incentives related to high standards of ethical business conduct should be included in the performance appraisal and remuneration structure for all senior managers in a company.

Global codes of ethical business conduct

- 2.24 Many companies set out their own standards of ethical business conduct in a global code of ethical business conduct (although not always called this). The global code should express ethical values as an integral part of the company’s core business values to encapsulate holistically “how we do business” and the standard against which behaviour and reputation is to be judged internally, and ultimately externally.

⁶ IBE Research, Phase 1, Appendix F.

The code and the standards each company sets itself reflect commitments by which a company, its Board, senior executives and all employees should be judged. Such a global code would be expected to:

- set out clearly the standards of behaviour required at every level in the company and of others associated with the company;
- emphasise the positive commercial benefits of high ethical business conduct, and not simply the negative consequences of getting things wrong;
- provide a means for employees to raise questions and concerns and be given support without fear of retribution;
- give a warning to expect disciplinary action if there are breaches of the requirements and a commitment to follow this through in appropriate cases;
- use clear and simple non-legalistic language to explain appropriate and inappropriate behaviours, with examples of ethical dilemmas, key questions to ask and where to go for further advice and guidance;
- include specific expectations of the behaviour of senior managers and be explicit that career development, remuneration, and other policies are aligned to reward and support those who promote and demonstrate such behaviours;
- include an explanation of how the ethics policies are implemented and embedded into business practice and the organisational culture (for example, training, the governance arrangements and the role of the Board and its Committees), and how implementation of the policies will be monitored and audited and publicly reported; and
- be a living document. Although core values and expected behaviours should be fundamental and permanent, the responsibilities and expectations on global companies for ethical business conduct are likely to continue to evolve. The code should be reviewed regularly (annually is best practice but at least every three years) with a mechanism for employees to submit their views and suggestions.

2.25 Such a code is necessary but only a first step. The critical challenge is its effective implementation and the embedding of ethical values within the corporate culture. This lies at the heart of how a global company can live-up to a common set of standards in the way it does business across different countries, cultures, political and legal systems.

Policies and procedures in key areas of risk

2.26 A good starting point is for a company to identify the particular areas of ethical and reputational risk to which it is exposed. Some will be common to industrial sectors and/or in particular countries. The policies and procedures applied to such areas will require an assessment of these risks. Difficult or grey ethical issues will be explicitly addressed, and thereby enable the policies to be meaningful in practice, particularly in countries where behaviour that may conflict with the global standards is legally permitted and/or a culturally accepted way of doing business. A company will also focus on what is required in order to ensure that third parties associated with the company adhere not just to the global code but, if appropriate, to more detailed policies and procedures, and devise mechanisms to achieve this.

2.27 Guidance and training will be provided to all employees and, where necessary, third parties on the global standards and their practical application, particularly in areas of high risk. An appropriate balance will be struck between using compliance-based, legalistic terms and those based upon the application of core

principles explained in everyday language. In areas of legal complexity and high legal risk there will be an element of the former but the latter will always be included so as to avoid an approach based solely on observing legal requirements without any assessment of the wider ethical risks.

- 2.28 Clear policies and procedures will also be in place for assessing and managing the risks when making a decision to proceed with a contract, acquisition or joint venture. Normal due diligence procedures will explicitly include ethical and reputational issues in addition to financial and operational risks.
- 2.29 The larger the company and the wider its spread of operations, the greater the likelihood that someone, somewhere, within or associated with the company, will be acting unethically despite all the best efforts to ensure this does not happen. A company should aim to develop an organisational culture that is self-policing and that positively encourages concerns about ethical behaviour to be raised at all levels and in all locations. In cases where things do go wrong, how a company is seen to respond will be critical to its reputation and whether it is perceived as living-up to its global standards. The reputational risks of dealing with an issue internally, compared to those of disclosing problems externally, will be addressed and balanced in line with the company's values. Additional tools for implementing the values and ethics policies will be in place.

Critical elements will include:

- promulgating the global code (in local languages where appropriate). This may include written acknowledgement of the contents and the requirement for adherence to it, by employees and also third parties with whom there is a contractual relationship;
- training at all levels on the values and ethics policy (in local languages where appropriate) and also specific training, for particular groups, on the detailed policies and procedures in key areas of ethical risk. Where appropriate this should be extended to third parties;
- specific functions within the company designed to support implementation. These should include one or more of telephone helplines, dedicated email addresses, and ethics officers, ambassadors or ombudsmen, who provide help and guidance, outside the operational line, and with whom concerns can be raised;
- alignment of Board policies to provide positive incentives (through appraisal and remuneration) and zero tolerance of unethical behaviour (disciplinary); and
- clear company policies for what happens when things go wrong, including the arrangements for internal investigation, reporting the outcomes to senior executives and the Board, and a presumption of disclosure of material findings to the relevant external authorities.

Assurance and reporting

- 2.30 It is essential for a company to have an effective process to assure members of the Board (particularly non-executive) and others inside and outside the company that values and ethics policies are robust and lapses minimised and appropriately dealt with. The assurance process will provide a measure of the extent to which employees have knowledge of, and adhere to, corporate standards and will be overseen and reported on by the Board Committee. The assurance process will include the regular programme of internal and external audits of ethical business conduct and the management of reputational risk. Key elements may also include⁷ staff surveys, exit interviews, evaluation of training, records of infractions and disciplinary actions, reports from telephone helplines, benchmarking against external standards,

⁷ IBE Research Phase 2, Appendix F.

and reports on the behaviour of third parties. The results of the assurance process should be published if the company is to demonstrate internally and externally that it is adhering to the highest standards of ethical business conduct.

Openness and transparency

- 2.31 A global company cannot meet its obligations on ethical business conduct and manage reputational risks without a corporate policy and culture of openness and transparency. In reputational terms, being seen to follow the highest standards of ethical business conduct is as important as doing so, and this applies both internally and externally. There is a distinction to be made between openness and transparency. A company may not, for legitimate commercial or confidentiality reasons, be able to be fully transparent about a particular activity or decision, but it can be open about the reasons why this is the position. If it does this, it is likely over time to command respect and draw reputational benefit from doing so. A company should ensure that:
- the global code and key ethical policies and procedures, and details of the mechanisms to implement the standards, are publicly available;
 - where allegations of misconduct are made, the company is open about the actions it has undertaken to investigate, and also about the outcomes; and
 - there is regular reporting, both internally and externally, on how the company is living up to its standards, derived from the assurance process.

Collective action

- 2.32 There may be some issues that are so pervasive or persistent within a particular sector that, despite best efforts of some individual companies, the risk of the reputational damage can only be addressed collectively and often in concert with governments and NGOs. There are some notable examples of this, including the Kimberley process to stem the flow of conflict diamonds⁸, and the Extractive Industries Transparency Initiative that promotes the publication of what companies pay and governments spend from revenues derived from oil, gas and mining⁹. A global company, through its engagement with competitors, NGOs and governments, should lead and take advantage of such opportunities for collective action. It should not be blinkered by the competitive pressures that may lie behind the continuation of practices that are the root cause of the reputational damage.

⁸ Details can be found at www.kimberleyprocess.com.

⁹ Details can be found at www.eitransparency.org.

SECTION 3

Business ethics and the defence industry

Introduction

- 3.1 In the preceding section the link between business ethics and reputation in the light of the responsibilities of global companies was examined and some indicators of the minimum levels we would expect to see in a global company addressing these responsibilities were set out. This section now examines these responsibilities in the case of a global defence company where particular complexities and constraints exist that increase the ethical and reputational risks. Together these form the essential reference points when considering the Committee's recommendations regarding ethical business conduct in BAE Systems plc in Section 4 of this Report.
- 3.2 This section draws upon research conducted on behalf of the Committee by Professor Sir Lawrence Freedman and colleagues from the Department of War Studies at King's College London¹ (KCL); the discussion that took place at the Roundtable Seminar² the Committee sponsored; and the results of the research by the IBE³. Finally the Committee has the benefit of information that it received in the course of conducting this Review⁴.
- 3.3 The Committee's starting point is whether being engaged in the production and supply of defence equipment is in itself unethical (or using the approach suggested in Section 2: "would the involvement of a company in this activity, in itself, lower its reputation in the mind of a right thinking person?").
- 3.4 One of the fundamental tasks of government is to protect the safety of its citizens. This is enshrined in the Charter of the United Nations⁵, which provides the right for individual countries to defend themselves. It is a responsibility of any sovereign nation, whose peaceful existence may or may not be protected by treaties or similar arrangements, to have the capacity to defend itself. A dependable access to defence equipment is essential. For this reason alone, the defence industry must be regarded as being capable of being ethical since it provides the means by which a government can protect its society.
- 3.5 The provision of the means to enable this right to be exercised in legitimate circumstance is in our view an ethical activity. This argument for the existence of defence companies, over and above their economic contribution, employment and technological innovation, is rarely heard from governments or the defence industry. It is an argument that could be made more often.

¹ A Dorman, L Freedman and M Uttley, "Pitfalls of the Defence Industry", King's College London, 2007, Appendix G.

² Details of the Roundtable Seminar, including a list of attendees and a summary of the discussion, are at Appendix H.

³ IBE Research, Appendix F.

⁴ A list of who the Committee met with and from whom submissions were received is at Appendix D.

⁵ Charter of the United Nations 1945, Chapter 7, Article 51.

- 3.6 This does not mean that all contracts for the supply of defence equipment are ethical. Whether they are depends on the circumstances of any particular contract with the relevant nation. Issues will include the risks of over aggressive use, including internal repression; creating regional instability; the products falling or being passed into the hands of unlicensed third parties; the nature of the products themselves; and the economic sustainability for the recipient.
- 3.7 These are issues that are in many respects primarily the responsibility of governments. However, this does not leave companies without major responsibilities, in particular in respect of developing countries, where global companies have a duty to provide leadership and, for example, to encourage responsible use of resources. They should not attempt to circumvent such responsibilities by seeking to delegate the reputational risk to which they might be exposed on any particular contract. The supply of defence equipment is an activity which imposes heavy responsibilities on the way in which the business is undertaken. The very nature of the products places a particular obligation on those involved in the production and supply to conduct, and be seen to conduct, business to high ethical standards.

Overview of the defence industry

- 3.8 In the decade that followed the end of the Cold War there was a significant decline in overall global defence expenditure. This has however been reversed by increased expenditure in the last decade. Expenditure in 2006 was over \$1,000 billion or approximately 2.5% of the world gross domestic product⁶. The US has by far the largest expenditure and the vast majority of the remainder is taken up by a relatively small number of other states of which the UK is one of the largest. Although overall expenditure may not continue to grow at this rate in future, and may decline in some countries and regions, it is and will continue to be, by any measure, a very large global industry.
- 3.9 Similarly, all major defence companies are drawn from a small number of countries, mainly the US and Europe, with the relative size of the largest increasing in the last decade through strategic mergers and acquisitions. This is arguably because of the complexities of technology, economies of scale in manufacturing, and the long life-time of major defence contracts. Unsurprisingly, it is from those countries with highest domestic expenditure (and where the largest companies tend to be principally based) that most of the defence equipment exports to other nations take place. The scale of this global market is significant with \$44 billion of export agreements in 2005⁷. There is an increasing trend for the recipients of such exports to seek to develop their own indigenous capacity as an integral part of such contracts.

The role of governments

- 3.10 National governments are normally the only legitimate end-customer for defence equipment. This factor, above all others, shapes the nature of business transactions in the industry both domestically and internationally. Historically most national governments tended to design and procure all their defence equipment. As the complexity and cost of defence equipment has increased, the number of countries that are financially and technically capable of meeting all their requirements domestically has declined, although the imperative (for the major nations) to ensure indigenous capacity and national autonomy remains strong⁸.
- 3.11 This has resulted in the significant trade of defence equipment between nation states. In addition to cementing geo-political relations such trade, for the “supplier” government, provides a mechanism to offset domestic research, development and production costs, and keep production lines open,

⁶ Stockholm International Peace Research Institute Yearbook 2007.

⁷ Ibid.

⁸ For example, the UK Government's Defence Industrial Strategy, Defence White Paper (HMSO, 2005), Cm 6697.

maintaining indigenous capacity, and helping to ensure the economic viability of the “national” defence companies. For the “recipient” government, it provides access to a level of military capability that it cannot provide from its indigenous capacity. “Supplier” governments assist their defence exporters by direct marketing support, providing export finance or insurance, and in some cases through government-to-government treaties and contracting structures. Defence exports are closely regulated in all major nations; typically, through the issuing of export licences from the government to the company, having been satisfied that the issues such as those highlighted in paragraph 3.6, do not arise, and alongside confirmation from the recipient government that the equipment is solely for its own defence purposes.

- 3.12 Governments, therefore, play multiple roles in close interaction with defence companies; as a customer, a marketer of companies’ products, and a regulator of to whom and what may be sold. This is in addition to the general role governments play in setting the overall economic and regulatory framework, including criminal law on issues such as bribery and corruption⁹.
- 3.13 As a customer, governments can impose price, specification and other conditions that decisively affect the outcome of a procurement process. Companies must judge whether the “price” of winning the business is consistent with its ethical standards and the potential reputational risk involved. In playing an active role in securing export contracts, governments agree and determine some key contractual terms through government-to-government treaties or less formal agreements. A company must balance such terms against its ethical standards and potential reputational risk. In complying with the spirit as well as the letter of an export licence, a defence company must also be clear how it manages the balance between customer confidentiality, trust, and any acquisition of material knowledge that is not held by the licensing government.
- 3.14 Managing these interactions in a way that is consistent with high ethical standards is complex enough where a defence company’s operations are primarily national. However, the gradual breakdown of national ownership patterns in the defence industry through mergers and acquisitions has led to global defence companies with operations providing indigenous capacity to many countries. This significantly increases the complexity of the various relationships with the governments involved.

The nature of defence contracts

- 3.15 The monetary value of many defence contracts is extremely high, particularly for the most complex and complete platforms (e.g. combat aircraft, warships and submarines) which can cost many billions of pounds. The period over which such contracts can run are frequently long and this is increasing as the trend to the provision, by the supplier, of “through-life”¹⁰ capability grows. It is not uncommon on major defence programmes for over 50 years to elapse between initial concept work and the final retirement of the product from frontline service. The standards of business conduct that were acceptable at the beginning of a particular project can become unacceptable well before the contract is completed, but may nevertheless be enshrined in contractual terms agreed many years before. The various stages of the contract, from initial supply to through-life support and modification, may raise different issues of ethical and reputational risk.
- 3.16 Most defence contracts, and often the procurement process, have stringent requirements of confidentiality because of concerns involving national security (for example, avoiding public disclosure of defence needs or capabilities). The lack of a reasonable level of openness and transparency creates a greater risk of perceptions of practices that would be deemed unacceptable against normal global business standards. Conversely, the strict confidentiality requirements make it more difficult for

⁹ A summary of the main anti-bribery and corruption legal regimes is at Appendix I.

¹⁰ The supplier may assume responsibility for delivery, maintenance, modification, retirement from service and disposal of the defence equipment.

companies subject to allegations of misconduct to refute the allegations without breaching their obligations to the customer government. For this reason it is even more important for defence companies to establish clear corporate ethical business standards and to be open and transparent about these.

- 3.17 In many defence contracts the price, technical performance and delivery times of the equipment being procured are necessary, but far from sufficient factors when competing for the contract. Other important, and possibly determining, factors will include the political commitment from the supplying nation, the political benefit to the recipient, credit and financing arrangements, Offset packages¹¹ and related technology transfer with the aim of supporting the development of indigenous defence capacity. These factors mean that most companies need to employ advisers (individuals or companies) to provide local knowledge of market specific procurement processes and practices. Some also act as an intermediary between the company and recipient government. The use of such advisers, particularly when they are paid by a commission, carries significant risk for the companies. The complexity and confidential nature of the contractual arrangements, and the significant financial stake an adviser may have in a successful contract, increases the opportunities and temptations for non-transparent payments.

Ethical and reputational risks

- 3.18 These complexities have contributed to the defence industry being perceived as lagging behind the standards of ethical business conduct adopted by global companies in other sectors. The complexities may have contributed to a resistance to greater openness and transparency, an unwillingness to set and commit to sufficiently high standards if these are not required by law, and consequently a lack of consistency in standards of business conduct across countries and cultures.
- 3.19 The privilege of having access to global markets therefore poses a significant challenge for global defence companies. There are strong arguments for defence companies to conduct, and be seen to conduct, their business to high ethical standards.
- 3.20 It is the provision by a defence company of the equipment to a country to enable it to defend its citizens that usually underpins its ethical basis. If it fails to do this, then it fails in its purpose. Only a government can determine its defence needs and a company is under a very heavy obligation to meet the needs of its own government (and others where the company is a major provider of indigenous capacity). However, the Board of a company has a duty to make choices. It cannot completely delegate to government(s) the ethical and reputational risks associated with what it supplies to whom, for what purpose and upon what terms. This can raise complex issues for a company that is a major provider of indigenous capacity in a number of countries whose governments may also wish to export such equipment to other countries.
- 3.21 As we have explained in Section 2, a global company's reputation is an asset which will be valuable by reference to global standards. A global defence company must take account of the governmental policies in all of the countries where it has operations, and in particular the government where it is domiciled, in deciding its policy for managing such risks and in key decisions for particular contracts. It must be the Board of Directors that sets and agrees such policies and ensures that high ethical standards are properly considered and adopted when it makes key business decisions.
- 3.22 In doing so the Board will ensure that there are global corporate policies that apply, based upon its ethical standards. These may, and are indeed likely, to exceed the legal requirements in some or all of

¹¹ In general terms these are compensation practices required as a condition of purchase to return economic benefits to the purchasing nation. See, paragraph 3.43.

the countries where it has operations. In cases where the local legal standard is higher, the local requirements must be applied. Where the legal standard in a particular country may be lower, the global corporate policy should always take precedence. This is an approach that a global defence company needs to apply when making decisions about what it supplies to whom, and for what purpose and upon what terms.

- 3.23 There are a limited number of international conventions that most countries are signatories to which completely ban the production, use, and in cases, possession of certain weapons¹², and any company involved in this would be in grave breach of the law. There are, however, other types of weapons not subject to prohibition that perhaps over time could be judged in the mind of a “right thinking person” as significantly lowering the reputation of a company engaged in production and supply. A global defence company will need to carefully and explicitly, at the Board level, consider the overall (global) reputational risk of being engaged in the production and supply of such equipment, balanced against meeting the stated requirements of a particular government.
- 3.24 Similarly, a Board will need to consider whether the contractual terms proposed for a particular contract meets its ethical standards and do not lay the company open to ethical and reputational risks, (for example where unusual and/or non-transparent payments are proposed by the customer). Here the company will wish to ensure through contract negotiation that the terms are consistent with its ethical standards.
- 3.25 There are extensive national and international regulations on which country can be supplied with what defence equipment and under what terms. Many nations are signatories to international non-proliferation regimes and all states are obliged to observe arms embargoes mandated by the UN. European Union (EU) member states are similarly obliged to observe embargoes and other measures imposed by the EU. Individual nations implement these commitments, and additional national restrictions, that can vary and may conflict from country to country. Typically this is achieved through an export licensing regulatory framework. Countries such as the UK and US have extensive procedures that govern export and re-export of defence and dual-use (either military or civil use) equipment and technology.
- 3.26 Clearly a defence company must have robust policies, procedures and a culture in place to ensure strict compliance with such controls, which must include ensuring that the licensing government has access to the same knowledge as the company and that where relevant information becomes available to the company, it is shared with the government. However, the fact that a government will permit and may encourage a particular export, although a strong factor, must also be balanced by a company against an assessment of reputational risk. Consideration must be given to the policies of other governments and in particular the government of the country where the company is domiciled. Consideration must also be given to other ethical and reputational risks identified for the particular export, which should include the likelihood of allegations of bribery or corruption tainting the contract, based upon the recipient country’s reputation.
- 3.27 A global defence company should have a global corporate policy and process for identifying (and if necessary rejecting) possible countries for export potential that explicitly includes assessment of ethical and reputational risk factors that go beyond whether an export license is likely to be granted. Any departure from this policy should only occur with the explicit agreement of the Board.
- 3.28 Finally, it is important to acknowledge that the types of decisions described above involving ethical and reputational risks are complex and may require difficult balances to be struck. There are often unlikely to

¹² For example, Biological Weapons Convention 1972 and the Ottawa Treaty (Anti-Personnel Mines) 1997.

be simple right or wrong answers and a company may be subject to criticism whatever its decision. Nevertheless, these form part of the responsibilities of a Board of a global defence company. Ultimately, the Board must be prepared to walk away from a contract that would expose the company to unacceptable risk, despite the wishes of the government(s) involved.

- 3.29 An important feature of discharging these responsibilities is to demonstrate externally how the Board has reached its decision. Despite criticism from certain quarters on particular decisions, clear reasoning for a decision will, because of its openness, deliver reputational benefit. A company will for the same reason in some situations, want to make clear publicly that it has “walked away” from potential business that would have exposed it to unacceptable ethical and reputational risks, even if commercial confidentiality prevents details from being disclosed.

Bribery and corruption¹³

The legal framework

- 3.30 Domestic legislation, making bribery and corruption of public officials a crime, was a well-established feature in many countries from the end of the 19th Century onwards¹⁴. For a large part of the 20th Century, however, bribery and corruption of foreign public officials by companies, could be considered as an issue for the country concerned and, if accepted practice in that country, considered part of the “cost of doing business”. It could be, if not openly, then tacitly condoned by companies’ home countries.
- 3.31 With the recognition of the insidious damage bribery and corruption causes to nations, particularly developing nations, there were considerable legal developments through the latter part of the 20th Century. The US was the prime mover with the passing of the Foreign and Corrupt Practices Act in 1977. This was followed by the Organisation of Economic Cooperation and Development (OECD) Convention on Combating Bribery and Foreign Public Officials in 1997, which has so far been implemented by 37 countries. The prohibition of bribery and corruption has thus become a well established, and increasingly important, global standard¹⁵.
- 3.32 Today, the ethical and reputational risks associated with bribery are at acute levels. Any defence company (indeed any company) must have a clear and explicit policy against bribery and the control procedures, training, audit and investigatory measures in place to prevent and detect bribery by, or of, an employee.
- 3.33 Increased attention, particularly in the defence industry, has been focused on indirect corruption by third parties with whom a company has a contractual relationship. Any analysis of past and present cases of transnational bribery demonstrates that third parties have very frequently been instrumental to the corruption. There is a distinction between a third party who is actively encouraged to bribe by the company on its behalf, or to whom a “blind eye” is turned, and a third party who acts covertly and in breach of the company’s rules without its knowledge. Nevertheless, the clear trend in regulatory requirements, particularly in the US, is to impose responsibility, and by implication ethical and reputational risk, upon the contracting company irrespective of whether it knew, or ought to have known, of corrupt practices by third parties.

¹³ “Corruption involves behaviour on the part of officials in the public sector, whether politicians or civil servants, in which they improperly and unlawfully enrich themselves, or those close to them, by the misuse of the public power entrusted to them.” Transparency International Sourcebook, 2nd edition, 1997.

¹⁴ For example, Public Bodies Corrupt Practices Act 1889.

¹⁵ A summary of the main anti-bribery and corruption legal regimes is at Appendix I.

Advisers¹⁶

- 3.34 A significant third party ethical and reputational risk to defence companies is posed by individuals or companies contracted to provide support and advice to the marketing and sales of defence equipment in a particular country. Advisers are often incentivised by commission payments on the successful award of sales contracts, and at a percentage of the contract price. These contracts can be of very large monetary value and commission payments correspondingly large¹⁷. This can mean an Adviser will have the capability, and some will be tempted, to obtain contracts with the aid of corrupt payments either with or without the knowledge or connivance of the company. The temptation creates higher risks for the company that bribery and corruption may occur, or at least may be alleged, in relation to the activities of the Adviser in assisting with the winning of a contract. A reputable company should take all practicable action to prevent this happening.
- 3.35 A defence company must therefore only appoint Advisers where there is a compelling business case for clearly defined services, and stringent control measures, based upon ethical and reputational risk, are followed to ensure due diligence in their selection, appointment, management and payment. The company's Board should be kept fully informed of action taken which should be closely audited. There must be careful definition of the Advisers covered by this process. It would be disproportionate to apply it to advisers providing professional services such as lawyers, accountants, tax specialists and outsourced specific services such as Public Relations and Human Resources. Such advisers are not paid by commission upon a defence contract being achieved. Nevertheless, the definition must not be interpreted so narrowly as to enable avoidance of the precautions that should be applied to Advisers who provide sales and marketing support to win contracts in both domestic and export markets.
- 3.36 The Committee examined a number of processes relating to Advisers that are applied by global companies, including defence companies, and a range of publicly available standards. In light of the significant risks and the particular impact this has had on the defence industry, the Committee believes it is necessary to set out in some detail how risks may be minimised by adopting a process that reflects the following key elements identified in its Review¹⁸.

The proposal for, and the selection of, an Adviser

- 3.37 Given the ethical and reputational risks the process must ensure there is a clear and demonstrable business need for an Adviser, with an explanation of why other means cannot be used to accomplish the task¹⁹. The business need must be documented and subject to the approval of the responsible senior executive or business unit head. Careful consideration must be given to the level of payments proposed for the Adviser. There needs to be a documented case providing objective justification for the proposed payments²⁰. Companies should create clear guidelines to assist the objective determination of proportionate payments for Advisers.
- 3.38 Once a prospective Adviser has been identified and proposed, there should be a comprehensive due diligence process. It should include requiring the prospective Adviser to complete a standard application form, providing information and external references to help assess their suitability for the task and whether appointing the Adviser would present any risks to the company. Internal due diligence should then be conducted by a central unit within the company, reporting to the senior company lawyer and supplemented in most cases by due diligence from an external third party. The due diligence process

¹⁶ Often referred to as 'advisers, agents, brokers, consultants, intermediaries, middlemen, or representatives'. Hereafter, 'Advisers'.

¹⁷ It should be recognised that despite an Adviser's efforts over what can be a significant period of time (in some cases, 20 years), it is possible that no sale will occur and the Adviser will receive no commission payment.

¹⁸ Appendix J sets out "cradle to grave" steps for the selection, (re) appointment, management and payment of Advisers.

¹⁹ An example could be the use, or establishment of, a local company office.

²⁰ An "objective justification" would be based clearly upon the task, the specific competences, expertise and experience required of an Adviser and the prevailing rates for such services.

should highlight any “red flags”²¹ that may arise in the appointment, management or payment of an Adviser.

Key Red Flags²²

- a history of corruption in the territory;
- an Adviser has a lack of experience in the sector and/or with the country in question;
- non-residence of an Adviser in the country where the customer or the project is located;
- no significant business presence of the Adviser within the country;
- an Adviser represents other companies with a questionable reputation;
- refusal by an Adviser to sign an agreement to the effect that he has not and will not make a prohibited payment;
- an Adviser states that money is needed to “get the business”;
- an Adviser requests “urgent” payments or unusually high commissions;
- an Adviser requests payments be paid in cash, use of a corporate vehicle such as equity, or be paid in a third country, to a numbered bank account, or to some other person or entity;
- an Adviser requires payment of the commission, or a significant proportion thereof, before or immediately upon award of the contract by the customer to the company;
- an Adviser claims he can help secure the contract because he knows all the right people;
- an Adviser has a close personal/professional relationship to the government or customers that could improperly influence the customer’s decision;
- an Adviser is recommended by a government official or customer;
- an Adviser arrives on the scene just before the contract is to be awarded;
- an Adviser shows signs that could later be viewed as suggesting he might make inappropriate payments, such as indications that a payment will be set aside for a government official when made to him; and/or
- there are insufficient bona fide business reasons for retaining an Adviser.

3.39 The identification of one or more red flags should immediately rule out proceeding any further with the appointment process or continued use of the Adviser, subject to further investigation where deemed necessary by the company and to a finding that the red flags can be satisfactorily resolved. There should be a face-to-face interview with any prospective Adviser, with a senior company lawyer in attendance, to explain to the Adviser the company’s policies on bribery and business ethics and assess understanding of how this would apply in practice for the proposed Adviser’s activities.

Review of the proposal

3.40 A proposal to appoint or reappoint an Adviser must be reviewed by the company’s senior lawyer or nominee and ideally a committee of experts, outside of the business or marketing function. The committee of experts should be given documentation on the business need for the proposed Adviser, the objective justification of any payments, the results of the due diligence and a report on the face-to-face interview. A recommendation should only be made to appoint or reappoint an Adviser when the committee of experts is satisfied the company will not suffer any reputational or other damage. The Board of Directors should endorse the committee of experts’ recommendation to appoint an Adviser and must explicitly sanction any appointment that is made contrary to the recommendation of the committee.

²¹ “Red flags” or “warning signs” are factors that may be used by companies to signify areas of ethical and/or reputational risk.

²² See also Appendix J.

Appointment

- 3.41 A signed standardised contract for a maximum term of two years²³ must exist between an Adviser and a company before work is undertaken by an Adviser on behalf of the company. The contract should include a requirement to adhere to the company's anti-bribery policies and global code and allow auditing and compliance checks to be made by the company. An Adviser should, on appointment and at regular intervals during the term of his contract, receive training from the company on its policies and what they mean in practice. Training programmes should be actively reviewed for maximum effectiveness. The contract should set out the payment levels and methods. All payments will be made directly to an Adviser in the country where the services are provided. Cash payments, payments to third parties, to numbered or off-shore accounts, or to some other person or entity must not be permitted. The contract should also allow the company to decide whether to disclose the identity and payment of an Adviser to the customer. It should be expected that the identity of an Adviser would be made known to the customer if an Adviser's activities are likely to require contact with the customer.

Management

- 3.42 A specified individual (principal contact) within a company should be responsible for the ongoing management and monitoring of each Adviser's performance and conduct. All Advisers should be required to submit regular activity reports detailing how they are undertaking the contracted services. The principal contact should use this and any additional information to monitor an Adviser's conduct with a view to identifying any red flags. The company's central unit should conduct repeat due diligence regularly, possibly annually. The results from this due diligence, along with confirmation from the principal contact that no aspect of an Adviser's conduct has given cause for concern, should be documented and reviewed by the committee of experts if there is a proposal to reappoint an Adviser. Where an Adviser breaches their contract with a company, the company should suspend all payments and terminate the contract. All Advisers should be required to indemnify the company for damages arising from the breach, including recovery of payments already paid in accordance with the terms of the contract.

Offset

- 3.43 A characteristic of virtually all defence contracts is the requirement placed on the contractor to provide industrial, commercial or other economic benefits to the recipient country as compensation for the main contract to supply defence equipment or services. This is known as Offset. Broadly, there are two types of Offset:
- direct, where the activity is directly related to the defence equipment being procured and intended to support the indigenous defence industry, for example through licensing production, co-production or use of contractors in the recipient country; and
 - indirect, where the activity is unrelated to the defence equipment being procured and may include purchases from, investment in, and technology transfer to, companies in the recipient country.
- 3.44 The nature of the Offset package proposed will frequently be a major determining factor in the award of the contract. The "value" of the Offset agreement can be 100% or more of the main contract price. Companies face heavy contractual penalties if they fail to deliver on their Offset agreement and many countries have detailed regulations and a dedicated organisation (often outside the defence ministry) to ensure that Offset projects meet required criteria. Credit multipliers are often used to encourage investment in key areas. Despite concerns that Offset distorts the procurement process and can often be used as a conduit for bribery, both the value and number of Offset agreements and transactions related to defence contracts remains high²⁴.

²³ Two years is the appropriate point to formally review the ongoing business need, performance and conduct of an Adviser.

²⁴ Offsets in the Defense Trade, Twelfth Report to Congress (US Department of Commerce, Bureau of Industry and Security, December 2007).

- 3.45 Offset represents a key area of ethical and reputational risk. Defence companies will often employ third party advisers to assist them in both the development of the Offset package as part of the procurement process and in the subsequent delivery of individual projects. This can expose the company to similar ethical and reputational risks regarding bribery and corruption as does the use of Advisers on the main contract. Offset contracts need to clearly demonstrate value for money if they are not to generate suspicions and allegations that their purpose is to hide a payment to a third party, and due diligence undertaken to ensure anyone involved in, or related to, the awarding of the main contract does not receive financial benefit from an Offset contract.
- 3.46 Given the high level of risk involved in Offset the Committee would expect a defence company to apply:
- the process described above (paras 3.37-42) for the appointment and reappointment of Advisers on the main contract, to advisers engaged to provide support for the development of Offset agreements and of the performance of Offset contracts; and
 - a strict due diligence process designed to scrutinise and assess ethical and reputational risks to all Offset agreements and Offset contracts. This should be an explicit part of the internal decision-making process.

Facilitation payments

- 3.47 A facilitation payment is typically the payment of a small amount to a government official to secure or expedite a routine governmental action, often to avoid bureaucratic delays or inaction if payment is not made. In most countries such payments are illegal but in some, particularly developing countries, they are commonplace and often accepted as a necessary supplement to the low incomes of junior officials, and may be part of an organised system with a percentage going to superiors. How a global company deals with this issue is not helped by the fact that OECD countries have taken differing approaches in their legislation on bribery of foreign officials. For example, the US specifically excludes facilitation payments from its definition of bribery but the UK, the Netherlands and Japan makes no distinction, although in their initial guidance they indicated that they were unlikely to prosecute companies for making small payments in countries where the practice is common-place²⁵. Most major companies explicitly forbid such payments but some accept that employees may need to make such payments, subject to certain conditions such as an obligation to report all such payments to the company's compliance unit and often only make them with approval from the company's lawyers.
- 3.48 On a pragmatic level the issues would appear to be one of the size of payments (a nominal sum does not in practice constitute bribery) and the practicality (indeed honesty) of an absolute prohibition on such payments where a company has operations in countries where they are commonplace. However, for a global defence company, with the background of risk from bribery and corruption associated with the sector, there are strong arguments against trying to introduce and explain distinctions between an acceptable facilitation payment and an unacceptable bribe. To do so risks sending a conflicting message to employees, Advisers and customers and may undermine the overall impact of its ethics programme. The approach adopted by a number of global companies, and one the Committee would anticipate a global defence company might adopt, is to forbid facilitation payments as a matter of global corporate policy, but recognise that it may not be possible to eliminate such payments immediately in some countries. Management and employees in such countries need to be supported to ensure all such payments are recorded and reported to senior executives and the Board of Directors and measures developed to eliminate them completely over time. This should include engaging in collective action with other companies and NGOs operating in that country and applying pressure on the local government to take action, if necessary with the assistance of the company's home government.

²⁵ J Bray, *Control Risks, Facing up to corruption 2007: A practical business guide*, (Simmons & Simmons, 2007).

Gifts and hospitality

- 3.49 It is often customary and appropriate in many cultures to make gifts and provide hospitality in the course of business. However, where the value or extent of either can be considered disproportionate, it risks being perceived as imposing an obligation or placing undue influence on the recipient and may be construed as a bribe. Companies should have clear principles and rules governing the offering and acceptance of gifts and hospitality and should be absolute in the prohibition of any circumstances that could place, or be perceived to be capable of placing, the recipient under an obligation.
- 3.50 The two key principles that should be applied are proportionality and transparency: could the gift or hospitality be considered disproportionate and would it cause embarrassment to the company if made public? The rules should impose limits of the monetary value of gifts (and ideally a range of corporate gifts that are available) and clearly define the circumstances where it might be appropriate to give and receive gifts. Similarly, the circumstances and types of acceptable hospitality should be set out. For both, there should be clear levels of senior management approval with documented justification of any exceptions to the limits. All gifts and hospitality above a modest threshold should be registered, and the registers subject to regular internal audit. It is also important that there are mechanisms for recording and monitoring the cumulative benefits provided to individuals and organisations.
- 3.51 This establishes the global standards. However, there may also be specific laws and regulations in different countries and additional rules for public officials. The policy must require adherence to these and clear guidance provided in each location to ensure that these are followed in addition to the corporate rules. Given the nature of defence contracting, global defence companies will need to be absolutely explicit to employees on the applicable rules for public officials and will have ensured that a clear understanding has been reached with each customer government on the application of the rules in practice.

Acquisitions, joint ventures and contractors

- 3.52 Any global defence company will be characterised by ongoing growth through acquisitions, a range of joint ventures with other companies and by a large number of contractors. The business conduct of any of these can expose a company to reputational damage and, given the scale and complexity of these relationships for a global defence company, are in themselves areas of high ethical and reputational risk. There are a number of key elements that we would anticipate a global defence company would have in place to minimise these risks:
- *Due diligence.* Where the company is considering entering a new business relationship, it should undertake a process of ethical due diligence alongside financial and other due diligence procedures. This will be designed to determine conformity with the company's code of ethics and identify risks and areas where changes in policy and practice are required if the new relationship is to go ahead.
 - *Requirement to adopt the code of ethics and other key policies and procedures.* For acquisitions, joint ventures and contractors, the company should require the adoption of its global code and relevant policies and procedures or equivalent standards.
 - *Support and guidance.* The company must ensure that it effectively communicates its standards to the business entity and makes guidance and training material available, providing access to key mechanisms such as employee ethics helplines.

Assurance and reporting

- 3.53 All areas that pose key ethical and reputational risks relating to allegations of bribery and corruption to a global defence company should be a priority for regular and sequential internal audit reports on compliance with the relevant corporate policies and procedures. The Board Committee should initiate

and receive these reports and oversee follow-up actions. External audits of the management of reputational risk and ethical business conduct commissioned by the Board Committee should focus on the effectiveness of the policies and processes relating to these key risk areas. Together, this will provide the basis for the Board to report publicly and provide assurance on the company's approach to such key ethical and reputational risks.

Observation 1 A global defence company aspiring to high standards of ethical business conduct will have in place policies and procedures, along the lines of those we identify, to effectively manage, audit and report on, the key areas of ethical and reputational risks relating to allegations of bribery and corruption.

Collective action by the defence industry

- 3.54 There are examples of collective action relating to ethical business conduct and anti-corruption measures in the defence industry. The most longstanding of these is the US Defence Industry Initiative on Business Ethics and Conduct (DII)²⁶, established in June 1986 in response to concerns about the conduct of US defence companies in relation to US Government defence contracting. Defence companies who are signatories (75 in 2007) to the DII are committed to adopting and implementing a set of principles relating to business ethics, including a code of conduct, training of employees, helpline and speak-up procedures, voluntary disclosure to appropriate authorities, and sharing best practice with other signatories. The CEO of each signatory company is required to certify compliance with the DII principles annually.
- 3.55 More recently, Transparency International (TI), through its UK Chapter (TI (UK)), hosted meetings chaired by Lord Robertson of Port Ellen, the former UK Secretary of State for Defence and Secretary General, North Atlantic Treaty Organisation (NATO), with the major defence companies of the US and Europe to develop proposals for international industry-wide anti-bribery standards. This group facilitated the setting-up of a pan-European initiative coordinated by the European Aerospace and Defence Industries Association of Europe (ASD). This has resulted in the agreement of the ASD member associations to a set of Common Industry Standards²⁷ on integrity practices and in particular, anti-corruption measures. Each member association (including the Society of British Aerospace Companies (SBAC) and the Defence Industries Council (DIC) in the UK) will now work to ensure their member companies sign-up to the standard. The ASD has also stated its intention is to widen this effort to include the US, Brazil, Canada and Japan.
- 3.56 These industry-wide initiatives are important attempts to address the reputational damage suffered by all defence companies from perceptions of unethical practices including bribery and corruption in the supply of defence equipment. They will help companies demonstrate a commitment to high standards of ethical business conduct. The Committee would expect a global defence company to be at the forefront and leading such initiatives with visible commitment and involvement from the CEO and senior executives.
- 3.57 Such industry-wide principles or standards, however, can only attempt to tackle the "supply side" of ethical and reputational risks in the behaviour of defence companies. They do not attempt to address the key characteristics of defence contracting which can create the environment where the risks of the contract being tainted by allegations of bribery and corruption are high. This was an issue raised and discussed at the Roundtable Seminar sponsored²⁸ by the Committee and a particular approach to the

²⁶ For further information see www.dii.org.

²⁷ Common Industry Standards for European Aerospace and Defence, April 2007, www.asd-europe.org.

²⁸ Appendix H.

problem is the subject of an initiative promoted by TI (UK)²⁹. Underlying these risks is the lack of transparency in the main and Offset contracts for defence equipment purchased by countries without a significant indigenous defence industry. There is a strong argument that it is in the interest of the defence industry collectively to promote and help purchasing countries to conduct such procurements with the maximum possible transparency. However, this requires leadership by the main global defence companies whose size and power can often dwarf the resources and expertise available to a procuring nation. It also requires recognition by those global companies that non-transparent aspects of such procurements, currently approached from a perspective of gaining and protecting competitive advantage, undermine the global reputation of the industry.

Observation 2 A global defence company aspiring to high standards of ethical business conduct should take an industry-leading position by actively developing, supporting and promoting initiatives designed to promote greater transparency in export contracts.

UK Governmental support

- 3.58 The primary responsibility for setting high ethical business standards lies with each defence company. However, where global companies are perceived to operate with low ethical standards, the reputational damage is not simply suffered by the company; the reputation of the country where it is based is also damaged. Such damage will adversely affect its international reputation and influence. In the case of the defence industry it may also detract from the public's confidence in the national defence procurement strategy. The UK Government has the potential to play a key role in encouraging and facilitating high standards of ethical conduct in the UK defence industry. This is a role it should exercise since it will help ensure the success of global defence companies generally in the UK, and this will in turn benefit the UK's economy and defence capability. It will also enhance the global ethical reputation of the UK, increasing the commercial and industrial standing of UK companies.
- 3.59 As a result of the Committee's discussions with senior officials from the Government departments with an interest in the defence sector, it is clear that the importance and benefits to the UK of encouraging high ethical standards in the industry is fully appreciated. However, there is a perception internationally that this has not necessarily been the case in the past.
- 3.60 In the defence sector, the distinction between private and public interest can be particularly difficult to define. The UK's ability to defend itself cost effectively depends upon the achievement of a significant level of exports to foreign countries. This blurs the line between the public and private interest. The UK Government has, with the 2005 Defence Industrial Strategy (DIS), clearly set out the role it expects the defence industry, and particularly indigenous industry, to play in supplying the nation's defence needs in the future. Part of this strategy includes an ever increasing emphasis on through-life support for defence equipment by the supplying contractor which has the potential to give a better alignment between the public and private interest. The achievement of, and public confidence in, this strategy, does however require an explicit recognition by the UK Ministry of Defence (MoD) and defence companies that they have a mutual interest in demonstrating high standards of ethical conduct.
- 3.61 It is to be welcomed that the MoD has recently revised and reissued its rules and guidance on procurement ethics to the Defence Industry Council (DIC) and defence companies, emphasising its importance. There are, however, other areas where external perceptions can cause both the MoD and the defence industry reputational damage, and where a clearer mutual understanding and agreement

²⁹ TI (UK) Programme, Defence Against Corruption: Defence Integrity Pacts, www.transparency.org.uk/programms/DAC.

on appropriate conduct could provide positive benefits. For example, the Advisory Committee on Business Appointments³⁰ expressed concern about the “traffic” of officials and service personnel to employment in defence companies. Also, while the number of formal government-to-government defence export agreements are small, a clear published understanding between the MoD and defence companies as to what terms might be incompatible with high standards of ethical conduct, could avoid some of the reputational issues that have arisen in the past. The implementation of the DIS and the recent transfer of the Defence Export Services Organisation (DESO) out of the MoD (see below) may offer an opportunity for the MoD to expand on its work with the defence industry (through the DIC) to agree how these potential ethical and reputational risks can be managed in the future.

Observation 3 The MoD could expand on its work with the defence industry to review the ethical and reputational risks faced as a result of the interaction between the government and the defence industry. A set of published protocols or a code of conduct could enhance public confidence and trust in both the defence industry and government.

3.62 On 25 July 2007, the Government announced³¹ the transfer of the function for the promotion and support of defence exports from the DESO in the MoD to UK Trade and Investment (UKTI), a public body reporting to the Department for Business Enterprise and Regulatory Reform (DBERR) and the Foreign and Commonwealth Office (FCO).

3.63 It is not the role of this Committee, nor is it in a position, to make any judgment on the efficacy of past or future arrangements. However, the Committee welcomes the Government’s view that.

“This transfer will also enable us to enhance support for defence exports in a way which emphasises our commitment to the highest business standards. UKTI Defence & Security Organisation will seek to assist the defence industry to achieve a more consistent performance across industry as a whole, demonstrably supporting good governance and responding to the compelling business case for transparency and ethical behaviour”³².

3.64 In the Committee’s view there is a compelling argument for the UK Government to become more proactive in encouraging high standards of ethical business conduct by UK-based companies accessing the global economy, and in particular in the defence industry, given the reputational issues that it has faced in the past. It appears that UKTI is now best placed to take the lead to do this within the UK Government. Both the reputation of the UK, and the global competitiveness of UK defence companies, would be enhanced by a proactive programme developed by UKTI to encourage the adoption of high standards of ethical conduct by defence companies wishing to export, in particular, in those areas of key ethical risk relating to bribery and corruption, highlighted earlier in this section (paras 3.30-57).

Observation 4 The reputation of the UK, and the global competitiveness of UK defence companies, would be enhanced by a proactive programme developed and promoted by UK Trade and Investment to encourage the adoption of high standards of ethical conduct by defence companies wishing to export, in particular, in those areas of key ethical risk relating to bribery and corruption.

³⁰ Sixth Report 2002-2004.

³¹ *Hansard*, 25 July 2007, column 83WS.

³² The Secretary of State for Business Enterprise and Regulatory Reform, *Hansard*, 1 April 2008; column 35WS.

Reforming UK law on bribery and corruption

- 3.65 The Committee has emphasised throughout the Report that compliance with the law is a minimum standard for any company and that a global company should aim for standards that are over and above the minimum required by legislation. However, all companies benefit from clarity in law and from a legal framework that provides positive encouragement to take proactive steps to minimise the risks of non-compliance. For a number of years there has been widespread agreement that this is not the case with the UK law on bribery. This has been exacerbated by the additional requirements to meet obligations to combat bribery from international conventions to which the UK is a signatory, including those relating to the bribery of foreign officials³³.
- 3.66 The OECD has been highly critical of the present UK law³⁴ and the absence of adequate reform continues to be damaging to the UK's international reputation and competitiveness of its global companies. Reform of the law has proved slow, difficult and contentious³⁵. However, the Law Commission published a comprehensive consultation paper³⁶ and the Committee considers that the proposals represent a clear way forward to reform the law in the UK.
- 3.67 The Committee welcomes the response given to the Committee by the Lord Chancellor and Secretary of State for Justice, the Rt Hon Jack Straw MP, who stated that:

*"Once their consultation is complete the Law Commission will work up their final proposals; we anticipate receiving their final report and draft Bill this Autumn. We await their final recommendations with interest, and we will then be seeking to bring forward legislative proposals as soon as parliamentary time allows."*³⁷

Observation 5 In light of the results of the consultation on the Law Commission's proposals for Reform of Bribery, the Government should quickly bring forward the necessary legislative proposals.

³³ OECD Convention on Combating Bribery of Foreign Public Officials in International Business Transactions.

³⁴ OECD Phase 2 Report on the Application of the Convention on combating bribery of foreign public officials in international business transactions 2005.

³⁵ See, for example, *Legislating the Criminal Code: Corruption* (1998) Law Commission Consultation Paper no. 248; and see Joint Committee on the Draft Corruption Bill, HL Paper 157, HC705 (2003).

³⁶ See *Reforming Bribery*, Law Commission Consultation Paper no. 185, November 2007. Consultation closed on 20 March 2008.

³⁷ Letter from the Lord Chancellor and Secretary of State for Justice, the Rt Hon Jack Straw MP, to the Rt Hon The Lord Woolf of Barnes, 28 February 2008, and referred to with his permission.

SECTION 4

Ethical business conduct in BAE Systems plc: the way forward

Overview

- 4.1 The preceding two sections set out the context and benchmarks for ethical business conduct by global companies generally and specifically in the defence industry. This provides the foundation for the Committee's assessment and specific recommendations in respect of ethical policies and processes in BAE Systems plc (the Company)¹. This section reviews the present situation in the Company before looking at the challenges it faces and our associated recommendations to the Board of the Company.
- 4.2 The Company has undergone a radical and very significant process of growth and change over the last 10 years. This has delivered commercial success for its shareholders. The journey has taken it from being an UK-based and export driven business, to being a major transatlantic defence company, to its emergence now as one of the prime global defence companies².
- 4.3 Being a global company brings with it the obligation to achieve high standards of ethical business conduct. The scale and nature of this obligation does not stand still. It is rapidly evolving and increasing. The Company's characteristics as part of the defence sector create additional complexities and constraints that must be overcome if this obligation is to be met. They include legacy reputational issues both for the Company and the sector more generally.

Ethical business conduct: foundations in place

- 4.4 The Company is in a sound position from which it can build to meet these issues and challenges. In the journey to becoming a global defence company, the Company has overcome issues relating to the management of financial and operational risk and now appears to have the robust systems and culture needed to effectively manage such risks.
- 4.5 There has been increasing recognition by the Company's Board and senior executives over the last five years of the critical importance of a similar focus on the management of reputational risk through high standard of ethical business conduct. This has not, however, been necessarily made widely known or communicated publicly.

The Board

- 4.6 The Board has adopted latterly a much more proactive approach to business ethics and reputational risks. This is demonstrated by the establishment of a Board Corporate Responsibility Committee (CRC) in 2005 with responsibility for oversight of business ethics, the publication of an annual CR Report since

¹ A description of the approach taken to this Review, and in particular the assessment of the Company's ethical policies and procedures, is at Appendix C. A list of individuals from the Company who the Committee interviewed and received briefings from, and a list of internal Company documentation reviewed by the Committee, is at Appendix D.

² Information about BAE Systems plc is at Appendix E.

2002 and, indeed, the establishment of this Committee. In addition the Board as a whole has received training in business ethics and has increased the weighting applied to senior executive remuneration packages for meeting ethics related targets.

Employees

- 4.7 The technical competence of the Company is highly impressive and it has a committed and professional workforce. The discussions the Committee held with members of the workforce and the Company's trade unions, at both national and local levels, emphasised the constructive employee relations that exist.

Ethical policies and procedures

- 4.8 The Company has set out global corporate ethical principles, alongside business values, in a user-friendly employee publication, "Ethics and You", with an associated basic online training programme for all employees. Work is underway to develop and implement a global code of ethical business conduct and reviews have been instigated of key ethical policies and procedures aimed at creating a more effective ethics programme and explicit reputational risk management. The Company has made an ethics telephone helpline available to all employees and undertakes regular surveys of employee views on ethics.

Exports

- 4.9 There are robust policies, procedures and an apparent strong culture of proactive compliance towards export control measures. The process for the assessment of the suitability of possible export markets is applied globally and now includes explicit consideration of risks of bribery and corruption as well as other ethical risks.

Advisers³

- 4.10 The Company undertook a fundamental reassessment of its contracts with advisers in 2007 to reflect a more robust focus on managing ethical reputational risks. This involved the termination of all existing adviser contracts held by the UK and a review of all contracts held by US businesses⁴. The process for reappointment (UK) and review (US) of advisers involved a review by a panel, chaired by a partner of a leading firm of solicitors. The panel currently consists of an internal counsel and external legal solicitors who are required to assess reputational risks as the key criteria when making their recommendations to the Company. This panel process and associated procedures will apply to the selection, appointment and management of all advisers in the future. The Company has indicated that as the new process matures it may seek to transfer the chairmanship of its panels to appropriately experienced independent individuals such as independent directors or others of similar standing.

Legal function

- 4.11 The legal and compliance function within the Company has been considerably strengthened over the last year. In addition, a senior company lawyer has been appointed to each operating business unit (except the US, where this was already the case) to ensure that legal compliance capability exists globally across the Company's businesses. The Company appears committed to adequately resource its legal function to ensure that legal and compliance risks are appropriately managed at business unit level and effectively overseen on a global basis by senior executives and the Board.

Salam project

- 4.12 In December 2005, a new defence cooperation agreement was entered into between the UK and Saudi Governments⁵, which included a commitment to the supply of Typhoon (Eurofighter) combat aircraft.

³ For a definition and discussion of 'Advisers' see Section 3 (3.34-3.42).

⁴ Adviser contracts held by the UK cover all export markets for the UK and countries reporting into the UK business. Similarly for the US. Appendix E provides more detailed information on the global structure of the Company.

⁵ Saudi British Defence Cooperation Programme.

The programme for the supply of Typhoon aircraft is known as the “Salam Project”. The Company, as was the case with the Al Yamamah (AY) programme is the prime contractor under a contract with the UK Government. The main contract for the supply of the aircraft was signed by the Company and the UK Government in October 2007.

- 4.13 The Committee have therefore, so far as this is practicable, tried to form a judgment on whether the Salam Project, and in particular the contractual terms entered into by the Company, are consistent with the Company conducting its activities in a manner that should not give rise to the same or similar reputational allegations, to those made in respect of the AY programme.
- 4.14 The Salam Project is an inter-governmental agreement directly connected with the defence capability of Saudi Arabia and there are therefore security obligations that stand in the way of providing the Committee with access to documentation concerning matters to which the Company is not party. However, in order to assist the Review, the Chairman and Secretary to the Committee were provided by the Company with commercial information about the contract the Company has entered into with the UK Government. That contract covers the supply of Typhoon aircraft under the agreement made between the two Governments.
- 4.15 The contract does not give rise to any special reputational risks to the Company. In particular it does not involve the employment or the payment of advisers on commission or otherwise. As required by the Saudi Government, the contract provides for a pricing structure that is comparable to that applicable to the RAF's own Typhoon programme. Further, all payments to the Company under the Salam Project are to be made by the UK Government, against invoices that can be audited in the normal way. Likewise payments from the Saudi Government to UK Government are made under arrangements approved by the Saudi Arabian Ministry of Finance. The performance of the contract between the Company and the UK Government is capable therefore of being included in regular reviews of the Company's management of reputational risk, carried out by the Company's external auditors as commissioned by the Board of the Company, and as we recommend later in this section (paras 4.81-82).
- 4.16 Accordingly, on the basis of this information, it appears to the Chairman that the contract entered into under the Salam Project should not in itself create any risks of unethical conduct by the Company. Further he considers there is no reason for the Company, under the Salam Project, to act in a way that is inconsistent with its responsibility as a global company not to conduct its operations in a way that gives rise to undue reputational risks.

Ethical business conduct: the future challenge

- 4.17 Notwithstanding what has been achieved already, the Company has continued to suffer reputational damage in respect of its business ethics. The damage flows directly from what is alleged to have happened in earlier years. Whether and to what extent any of these allegations are justified, the fact is that many of the external interested parties with whom the Committee spoke still perceive the Company to have been overly secretive, defensive, unwilling to explain its actions and at best lukewarm to the challenge of dealing with the major reputational issues affecting the Company and industry. There is scepticism as to what extent the Company has left its legacy problems behind.
- 4.18 Taken together with the Company's rapid evolution into a global company and the characteristics of the defence sector this means that:
- the rate of progress must be accelerated, sustained and embedded within the Company's culture;
 - internal and external assurance of higher standards of ethical business conduct is required;

- this must be demonstrated through greater openness and transparency internally and externally; and
- the Company needs to raise its sights above that of becoming a leader in its sector, to match the benchmarks set by global companies in other sectors.

4.19 The Company has to complete the transition through its legacy problems and embed an ethical approach. This will generate an enhanced share value through an increased ability to compete and the proof that the Company is one whose high ethical standards complement its world-leading technical expertise. Its outstanding technical competence, matched by its impeccable ethical standards, will effectively become part of its global brand.

4.20 Alongside its external impact there will be the critically important internal impact of the knowledge that the Board expects the Company to achieve high ethical standards in everything it does. This public commitment to excellence, strongly communicated internally and externally, is the key to continued success. To achieve this degree of excellence requires a sustained programme of change with clear and visible personal leadership from the Board and senior executives. We believe from our discussions and material examined that this is a view shared by the Board and senior executives and that such a programme has begun. The recommendations which the Committee makes are designed to:

- provide material reinforcement of the high-level commitment that already exists;
- help build the robust corporate governance arrangements that are required for the effective management of reputational risk through high standards of ethical business conduct;
- guide the work already underway, including the development and implementation of a global code of ethical business conduct;
- help embed a culture of openness and transparency;
- strengthen policies and procedures in key areas of ethical risks; and
- overall, provide a route map for the Company to establish a global reputation for ethical business conduct that matches its reputation for technological innovation and delivery.

Recommendations⁶

Aspiration of the Company

4.21 The Company's leaders recognise the importance of a clear corporate focus on high ethical standards and the management of reputational risk and the critical role this plays in ensuring its sustained long-term success as a leading global defence company. This was reflected by the Chairman, who expressed the hope that the Committee's Report would "tell us how to be the very best in the world. Not just okay, but a world leader"⁷. The Board needs to be clear and explicit about its long-term aspiration for the Company and how it proposes to convince its customers, shareholders and external interested parties of its determination and capacity to achieve it. Any global company wanting to ensure its long-term legitimacy and reap the benefits of an enhanced reputation in the global market will need to have, and be seen to have, high ethical standards based on their values. The defence industry faces some particular complexities and challenges but also has the duty to achieve and demonstrate such standards.

⁶ A consolidated list of all our Recommendations and Observations (made in Section 3) can be found at the end of Section 5.

⁷ Speech by R L Olver, European Business Ethics Forum, January 2008. www.baesystems.com/Newsroom/SpeechesandPresentations.

- 4.22 It is for the Board to decide and set the aspiration of the Company. This should embrace leadership among global companies generally and not only in the defence sector. The clear communication of the Company's aspiration, both internally and externally is, in our view, the critical next phase towards the implementation of our recommendations, which then should be fully embedded in the Company's corporate culture over the next few years and sustained in the future.

Recommendation ①

The Board of Directors should decide and communicate the Company's strategic aspiration and intention to be a leader in standards of ethical business conduct among global companies.

Openness and transparency

- 4.23 The development of a corporate culture, visibly demonstrated by the Board and senior executives, promoting and supporting openness and transparency about ethical matters, is essential in achieving and demonstrating high standards of ethical conduct. There is a greater probability that decisions requiring an assessment of ethical and reputational risks will be sound if the culture involves open and frank discussion about the issues. People within and connected to the Company are more likely to raise ethical issues and report problems if they can point to corporate standards of behaviour that are widely-known and well-understood.
- 4.24 The defence industry is characterised by a history of state ownership and stringent requirements of commercial confidentiality and national security applying to most of its activities. Generally, the sector has only recently experienced pressure to be open and transparent about its business conduct compared to other sectors. While concerns regarding national security are unavoidable in many of its activities, this has led to a greater culture of secrecy on the part of the Company than is necessary or desirable. The benchmarking research conducted by the IBE⁸ and other material reviewed, indicates that the Company seems to be less transparent about its ethical business conduct policies and procedures and less open in its responses to allegations of misconduct than other global companies and some of its industry peers.
- 4.25 On a number of occasions during this Review, external interested parties suggested to the Committee that the Company should adopt policies and procedures that, in fact, the Company already had in place. This is an example of inadequate communication and where the Company could make some significant, and relatively simple, improvements. The development and publication of a global code will be an important tool to help explain internally and externally the Company's ethical approach. In addition, as a matter of policy, the Company's ethical policies and procedures should be placed on the Company's internet site. The Committee accepts that the ability of the Company to be transparent about its response to allegations of misconduct has been limited and constrained by issues of confidentiality as well as possible legal implications. Nevertheless, the Company should balance these constraints against the advantages of being more open about the action it has taken internally to investigate allegations of misconduct, often involving the use of independent external experts. The discussions with external interested parties, and the experience of other companies, highlights that the reputation of a company for its ethical conduct depends as much on how it is perceived to have responded to substantive allegations of things going wrong, as it does on its stated ethical standards.

Recommendation ②

The Company should be an advocate of its own ethical standards and must adopt the principle of openness and transparency. All ethical business conduct policies and procedures must be publicly available and easily accessible. The Company should be open about the actions it has undertaken to investigate allegations of unethical behaviour and about the outcomes.

⁸ Appendix F.

A global code of ethical business conduct

4.26 In Section 2 the existence of a global code of ethical business conduct (“global code”) was identified as an important indicator of the minimum level expected of a global company at the leading edge of managing reputational risk. The Company’s lack of a global code was highlighted by the benchmarking research conducted by the IBE and had already been recognised by the Company as being an area in need of attention.

4.27 It is important that the Company already has a major project underway to develop a global code that will be integrated into its corporate governance structure and provide the basis for ensuring the supporting global policies and procedures are comprehensive, consistent and consolidated. The global code should be completed, published and promulgated globally across the Company towards the end of 2008, and should be followed by a major implementation programme. This will offer an opportunity for the Company to establish global corporate ethical standards that reflect its aspiration. Drawing upon this, and the benchmarks identified in Section 2, the Committee would expect the Company’s global code to:

- reflect the Board’s aspiration for the Company to become a leader in standards of ethical business conduct among global companies and their commitment to a policy of openness and transparency about business conduct;
- set out clearly the standards of behaviour expected of employees at all levels and others associated with the Company. Such standards should be aimed at being over and above basic legal requirements;
- require that the standards should be applicable globally throughout the Company regardless of location. Where differences exist as a result of local customs, laws or regulations, the global requirement will be applied, unless the local requirement sets a higher standard;
- provide the means for employees and others associated with the Company to raise questions and concerns;
- make clear that if employees face a dilemma the code will take precedence, and that employees will be supported if they do this;
- give a warning to expect disciplinary action if there are breaches of the requirements (and a commitment to give effect in appropriate cases regardless of where and by whom);
- require others closely involved with the Company to adhere to the code;
- set specific behavioural expectations for managers;
- provide guidance in a user-friendly style on identifying potential or actual unethical behaviour;
- provide for a regular review of the code;
- set-out the principles of implementation;
- be translated into all appropriate languages; and
- be published.

Recommendation 3

The Company should develop, publish and implement a global code of ethical business conduct. The Board should ensure the proposed global code is comprehensive and reflects the high standards of ethical business conduct consistent with the aspiration and intention to become a leader among global companies.

Role of the Board of Directors

- 4.28 Throughout this Report the Committee have emphasised that the effective management of reputational risk by adopting high standards of ethical conduct should be at the centre of corporate governance in a global company. This places a heavy responsibility on the Board of Directors to ensure and assure that such high standards are followed in practice. How the Company's Board, and in particular its non-executive members, fulfill these responsibilities now and in the future, is of central importance to its future reputation and continued business success.
- 4.29 The Board clearly appreciates the importance of effective management of reputational risk, and achieving this by ensuring high standards of ethical business conduct. In the course of the Review it has become apparent that the Board has been increasingly proactive in ensuring the appropriate policies and procedures are in place in key areas of ethical risks. The Committee's expectation is that in three years the Board will have:
- set the aspiration for the Company to be a leader among global companies for its ethical business conduct;
 - set the global corporate standards that apply and can be effectively translated to every area of the Company's business;
 - ensured a sustained programme of change is developed and implemented to achieve these standards, supported by clear and visible personal leadership by the senior executive and the continuous alignment of corporate policies and procedures, including the remuneration of senior executives;
 - ensured these standards are kept under regular review; and
 - ensured issues of ethical business conduct and reputational risks are explicitly addressed in the course of reaching any significant business decisions.

Recommendation 4

The Board should develop its increasingly proactive role in ensuring high standards of ethical business conduct in all the Company's activities. It should be a standing item on its agenda. There should be an explicit assessment of ethical and reputational risks in all business decisions taken by the Board. Board members should themselves be exemplars of the standards set out in the global code and receive regular briefings on emerging issues in business ethics.

Role of the Corporate Responsibility Committee (CRC)

- 4.30 The increasing importance attached by the Board to the issue of ethical business conduct is reflected in the creation of the CRC consisting of four non-executive directors in 2005. In addition to ethical business conduct the CRC is responsible for assisting the Board in discharging its responsibilities across the corporate responsibility agenda including issues such as workplace health safety, product safety, and community engagement. The approach to these (and other corporate responsibility issues) is, a manifestation of the wider ethical culture prevalent in any company. The responsibility for ethical business conduct therefore sits well with the CRC.

- 4.31 The CRC receives reports on “non-financial” risks identified through the Company’s six monthly operational assurance process; conducts an annual review of reports received through the employee ethics helpline; reviews the UK employees’ ethics survey; and reviews the annual CR Report before it is approved by the Board.
- 4.32 This initial role of the CRC in relation to ethical conduct is primarily reactive. A more proactive, challenging approach is now required to provide the necessary assurance that an effective programme is being developed and implemented by senior executives to achieve the Company’s aspiration for high standards of ethical business conduct. This was recognised by the CRC and more widely within the Company. The CRC has now identified ethics and safety as being among its key priorities for 2008. This needs re-emphasising in its terms of reference.
- 4.33 While the Committee recognises that the resources and capacity required may take time to put in place, it is a matter of urgency and priority that the CRC is able to fulfil a corporate governance role that provides assurance regarding reputational risks the same way the Audit Committee performs that role in relation to financial risks. The Audit Committee (in common with most Board Audit Committees) is already fully committed in discharging its responsibilities in respect of financial risks. The requirement identified in Section 2 for global companies to establish similar framework for the management of reputational risk may be best assured by the CRC (paras 2.20-21). It should be fully supported by senior executives and have sufficient other resources at its disposal.
- 4.34 The CRC’s agenda of priorities should require that:
- a sustained programme is implemented to achieve the standards set out in the global code;
 - those standards to be kept under regular review;
 - effective processes are in place to ensure issues of ethical and reputational risks are explicitly addressed when making significant business decisions;
 - internal audit reports are initiated in areas of potential risks;
 - allegations of breaches of ethical policies are promptly and thoroughly investigated and actions recommended;
 - the Annual Report and the CR Report includes an examination of ethical business conduct within the Company; and
 - the performance of ethical business conduct is monitored.

Recommendation 5

The Board Corporate Responsibility Committee (CRC) should have primary responsibility for oversight and reporting on standards of ethical business conduct and the management of reputational risk. This role should be performed as the Audit Committee performs its task of managing financial risk.

- 4.35 If the CRC is to perform this role effectively it must receive regular reports on the effectiveness of policies and procedures, compliance issues arising, and progress with the implementation of the global code.
- 4.36 Sufficient resources and training must be provided to the compliance and internal audit functions so that the management of reputational risk can be assessed in real time within business units on a daily basis

and alongside financial risks as part of the Company's programme of audits. The expanded skills set for the internal audit function in relation to reputational risks will need to be developed over time. The CRC will need to identify compliance and audit reports that identify weaknesses or problems with the management of reputational risk, and be able to ensure appropriate action is taken by senior executives. The CR and Audit Committees will need to work closely together, not least in ensuring that the annual programme of internal audits achieves the necessary scrutiny of areas of high ethical and reputational risks. As for financial risks, there will also be a need to external independent audit of ethical and reputational risks which we deal with later (paras 4.81-2).

Recommendation 6

The Company's Internal Audit function should ensure that ethical business conduct and the management of reputational risk is specifically assessed in all audit reports and the results, and progress made against recommendations, provided to the CRC. The additional skills and resources required for Internal Audit should be provided to achieve this. The CR and Audit Committees should hold at least one joint meeting a year to decide on the preparation of the annual internal audit programme.

Role of senior executives

- 4.37 Senior executive leadership on ethical business conduct is essential if the necessary standards are to be embedded in the organisational culture of the Company. It is the CEO and senior executives who have the responsibility to develop and implement the policies of the Board. There is recognition by the most senior executives within the Company of this critical role. We observed a number of specific examples that demonstrated the development of clear leadership on these issues and in the regular communication of the importance of high standards of ethical conduct to the long-term success of the business. An example is the manner in which the Executive Committee⁹ has set performance in ethics as one of its top 10 objectives for 2008. Another is the decision taken early in 2007 to commit additional resources to create a global compliance function providing an oversight of compliance standards within the business units. The challenge is to ensure priority is given to the implementation of the global code, that this is cascaded down to all senior executives, business unit heads and all staff, and that this continues to be a key priority.
- 4.38 It is also critically important that senior executives and business unit leaders publicise the importance attached by the Company to high standards of ethical conduct and the role this plays in ensuring long-term success. This is one way the Company can counter the external perceptions that the Company adopts a lower profile on these issues than some other global companies.

Recommendation 7

Members of the senior executive team and heads of business units have both a personal and collective responsibility to demonstrate high standards of ethical business conduct and to achieve effective implementation of the global code. Both should be reflected in their performance appraisals and in the variable element of their remuneration.

- 4.39 In many companies, particularly in the US where it has become almost mandatory, the programme to embed ethical values is the responsibility of a network of specific ethics officers in each business unit who report back to a senior ethics executive at corporate headquarters. This is the position in the Company's US business but not in the UK and other businesses. In some other companies there are also ombudsmen (or ambassadors) who have responsibilities for assisting the implementation of ethical policies. There are varying models for the ombudsman function. Generally, this involves a

⁹ 9 senior executives, chaired by the CEO. Appendix E provides further details.

network of individuals across all businesses and geographical locations, with whom employees can, in confidence, raise ethical concerns, make suggestions and seek guidance outside the normal reporting lines. In a company with global spread this ensures there are “neutral” individuals, who can speak the local language and understand the culture and business environment, available to deal with employee’s concerns.

- 4.40 Many companies believe that these individuals can play a positive role in helping to embed an ethical culture. The Company’s Board must consider whether extending the ethics officer model from its US business or adopting an ombudsman type model across the whole company would assist in the implementation of its global code. However, care must be taken to ensure that the presence of such a network does not unintentionally place the issue of ethics outside the operational line. We have emphasised throughout this Report that ethical business conduct and the management of reputational risks must be an integral part of a global company’s day-to-day operations. This is best achieved if each senior executive, and through them the heads of business units, has personal responsibility to demonstrate adherence to high standards of ethical business conduct and to ensure effective implementation of the global code. If networks of ethics officers and/or ombudsmen can support the senior executives and heads of business units in discharging their personal responsibilities, without detracting from those responsibilities, then this could be a valuable tool for the Company to consider adopting.
- 4.41 Notwithstanding the above, there needs to be a senior executive and supporting team in the corporate headquarters with overall responsibility for the programme to implement the global code. The Company currently has a Corporate Responsibility executive who, together with a small team, reports to the Group Human Resources (HR) Director. The CR executive has responsibility for the development of the global code. However, this executive needs to have the authority to challenge and support all other senior executives and heads of business units to ensure they discharge their responsibilities in this area. Consequently, the importance of these issues and the need to send a clear signal internally and externally of leadership commitment leads us to conclude that the HR reporting line should be discontinued. This is a role that in future should report directly to the CEO and have direct access to the Chair of the CRC. The CRC will primarily rely on this executive and their team to ensure that it has the necessary support and information to discharge its responsibilities, including the internal audit programme on the management of ethical and reputational risks. It is therefore a critical role.

Recommendation 8

There should be a senior executive, supported by a sufficiently resourced team, reporting to the CEO and with direct access to the Chair of the CRC, who has responsibility for the programme to ensure and assure there are high standards of ethical business conduct across the Company.

Decision making in the Company

- 4.42 The Committee has observed there are robust and structured processes in the Company for ensuring decisions involving financial and operational risks are taken at the appropriate stage and the appropriate level up to and including the Board. In particular, the “Life Cycle Management” framework mandates phased reviews of projects. These structures are supported by a system of internal controls based upon the “Operational Framework”, setting out top-level roles and responsibilities, delegating authorities, and mandating the policies and processes that must be applied across the whole Company and by every employee. Senior executives and heads of business units must sign a half-yearly self-assessment to verify compliance with this framework. Compliance with policies relating to ethical business conduct are part of this mandated framework and assurance process. The assurance process also includes a requirement to report key risks.

4.43 The Company is already working to fully integrate its enhanced focus on the management of ethical and reputational risks into these decision making processes and operational and assurance frameworks. It is recognised that the identification, reporting and management of these risks is less mature throughout the Company than the equivalent process for financial and operational risks. In Section 3 we highlighted some of the complex and difficult decisions involving ethical and reputational risks that a global defence company must make (paras 3.18-29). We have observed that the Board and senior executives are engaged in these decisions and that such risks form a key part of these considerations. The global code, and revised policies and procedures in key areas of ethical risks (see below para 4.44), should provide a clearer basis to formalise this. This should ensure the decision making processes at all levels across the Company require an explicit consideration of ethical and reputational risks and is fully reflected in the control and assurance processes including ratification by the Board.

Recommendation 9

The Company should develop formal processes to ensure business decisions are only taken following an explicit consideration of ethical and reputational risks. Where such risks are identified, the process should ensure any decision to proceed is taken at the appropriate level, and should include ratification by the Board.

Review of key ethical policies and procedures

- 4.44 In Section 2 we identified the breadth and scope of the factors that may be covered by the term ethical business conduct (para 2.8). Their scale means that business ethics should be an integral part of all the Company's corporate policies and procedures.
- 4.45 The Company has a suite of mandated policies and procedures for dealing with key areas of ethical risks. These are consistent with, and should ensure, compliance with the applicable anti-corruption legislation which, as we set out in Section 3 of this Report, is a key area of ethical and reputational risks for defence companies (paras 3.30-57). The Company has published five globally applicable principles of ethical business conduct : Accountability; Honesty; Integrity; Openness and Respect. These are supported by the publication, "Ethics and You", which sets out the main ethical dilemmas that an employee may encounter and where they may go for guidance and advice, including the confidential ethics helpline; and emphasises the Company's anti-bribery and corruption policies and the need to ensure high standards of workplace behaviour. Adherence to the requirements of "Ethics and You" is part of the Company's Operational Framework and the associated six-monthly self-assurance reporting by heads of business units.
- 4.46 There are two key suites of supporting ethical policies: "Integrity in Business Dealings", concerned with ethical compliance and which is the responsibility of the Group General Counsel; and "Personal Accountability", concerned with workplace behaviour and employee responsibility, which is the responsibility of the Group HR Director. Compliance with these policies is also mandated through the Operational Framework.
- 4.47 As part of the project to develop a global code, the Company has commenced a programme to review and revise key policies and procedures. A revised procedure for the selection, appointment and management of Advisers¹⁰ (one of the policies and processes that form part of "Integrity in Business Dealings") has already been developed and put in place by the Company. This is an example of the approach that should be adopted by the Company in other areas of key ethical risks.
- 4.48 The programme of reviews offers an opportunity to produce a consolidated and comprehensive suite of globally mandated policies and procedures, supportive of the proposed global code, and which provides employees with a clear pathway to understanding how the Company's standards of ethical conduct can

¹⁰ For a definition and discussion see 'Advisers' in Section 3.

be applied in day-to-day business situations that are likely to be encountered in a company operating globally. This should address any confusion generated by the somewhat fragmented nature of the current policies and procedures. Critical to the approach will be to ensure decision making processes in each area require an explicit assessment of ethical and reputational risks, over and above any legal risks, and the satisfactory resolution of any such risks achieved before proceeding further. This is an approach which should be adopted in the planned reviews of areas of key ethical risks and should underpin a programme of regular reviews thereafter.

Recommendation 10

Policies and procedures in areas of potential ethical risks should be regularly reviewed, with particular attention to the areas of greatest risks. The planned programme of reviews by the Company should ensure a consolidated and comprehensive suite of policies consistent with the global code, providing employees with a clear pathway to understanding how the Company's standards of ethical conduct can be applied in day-to-day business situations.

Areas of key ethical risks

4.49 As part of this Review the Committee examined the policies and procedures in some key areas of particular ethical risks, including those that are the subject of "Integrity of Business Dealings", and the others areas identified in Section 3 as areas of specific concern for defence companies (paras 3.18-52). All of these have, or should be, subject to review by the Company. The Committee makes the following recommendations to the Company in these key areas of ethical risks:

Selection, appointment and management of advisers

4.50 In Section 3 the significant third party ethical and reputational risks to defence companies by individuals and companies contracted to provide support and advice in the marketing and sale of defence equipment in particular countries were discussed. Key elements of process that adequately minimises these risks in the selection, appointment and management of such advisers were identified (paras 3.34-42)¹¹. The Committee's assessment of the new process put in place by the Company from April 2007 is that it meets or exceeds each of these critical elements and therefore now represents leading-edge practice. In particular, it is important to highlight that:

- in order to implement this new process the contracts of all existing advisers were either terminated, with proposals for reappointment to go through the new process (UK-held contracts), or subject to review (US-held contracts) using the new process. All future proposals to appoint or reappointment an adviser will be subject to this process;
- any proposal to appoint an adviser must be supported by a comprehensive and documented business case establishing the business need, with a clear description of the activities to be undertaken, an objective justification for the proposed payments, and a description of the results of a robust due diligence process designed to identify a wide range of possible "red flag"¹² issues; and
- all such proposals are subject to a central review process by the "Marketing Adviser Compliance Panel" chaired by a partner of a leading firm of solicitors with two other lawyers, one external and one internal to the Company. The panel is required to satisfy itself, among other matters, that there is demonstrably no risks of actual or apparent corruption of any kind and there is no reputational risk to the Company in the proposed appointment. Only if these significant tests are met should the panel recommend to the Company that an appointment can proceed.

¹¹ Also see Appendix J.

¹² Section 3 paragraph 3.38.

- 4.51 Together this represents a robust approach to this area of high risk. The combination of the rigour of this process and the Company's increasing focus on a more limited range of overseas markets has meant the number of advisers under contract with the Company has been significantly reduced. It is anticipated the number of advisers currently contracted to the Company will remain at a similar level in the future.
- 4.52 Work is now underway within the Company to fully codify this new process and integrate it within the operational framework with associated guidance and mandatory training for all employees involved in the selection, appointment and management of advisers. This must be a priority and is necessary to ensure it is embedded in the day-to-day approach of all those within the Company who are involved with advisers.

Recommendation 11

The Company should ensure that the new process for selection, appointment and management of advisers is fully codified and integrated into the mandatory policy and procedures of the operational framework, and that appropriate guidance and training in the process is provided to all relevant employees. This should make explicit:

- **a requirement to undertake face-to-face interviews, involving a company lawyer, as part of the due diligence process with all advisers whose activities require the interaction with potential customers;**
- **a general presumption that the identity of such advisers will be made known to potential customers; and**
- **endorsement by the Board of the adviser panel's recommendations and their explicit approval of any decision to make an appointment contrary to the panel's advice.**

Offset policy

- 4.53 The Company, in common with all major defence companies, has significant Offset¹³ obligations associated with its defence export contracts. Meeting Offset requirements and/or proposing Offset benefits forms a key element of bids for most export contracts. As we set out in Section 3, Offset can represent a key area risk (paras 3.43-46). Risks can occur through the employment of third party advisers to assist in the development of Offset packages and in the delivery of individual projects. The contracts need to demonstrate that the Offset represents value for money and avoids providing inappropriate benefits to anyone involved in, or related to, the awarding of the main contract; if there are to be no suspicions that their purpose is to hide payments to third parties. The Company currently performs a basic-level due diligence on advisers employed in relation to Offsets. There are company-wide mandated policies, procedures and guidance for the management and implementation of Offsets, which form part of the Operational Framework and decision making processes for any export contract. However, no explicit assessment of ethical and reputational risks is currently required.
- 4.54 The level of risk posed by Offsets means that they should be given priority treatment in the Company's planned review of policies and procedures. That review should focus on ensuring a similar robust approach to ethical and reputational risk management as that being applied to the selection, appointment and management of advisers.

¹³ For a description of Offset see Section 3 paragraph 3.43.

Recommendation 12

Advisers engaged to assist in Offset arrangements in export contracts should be subjected to the same due diligence and approval process as Advisers on the principal export contract. Offset contracts should be subject to a due diligence process requiring an explicit assessment of ethical and reputational risks and be capable of being audited for this. The Company should also be proactive in encouraging greater scrutiny and transparency by governments of the Offset elements of defence contracts.

Facilitation payments

- 4.55 The Company has a clear global policy prohibiting facilitation payments. As part of the review of key policies and procedures, it should consider the extent to which it recognises that it may not be possible to eliminate facilitation payments overnight in some of the countries where it has, or plans, operations. In such countries the Company should ensure that where payments occur they are recorded and reported (through the operational assurance process). Measures must then be developed to eradicate such payments over time. Where practical this should be done in conjunction with other companies, NGOs, the country's government, and if necessary with the assistance of the UK Government.

Recommendation 13

The Company should continue to forbid facilitation payments as a matter of global policy. While it may not be possible to eliminate such payments immediately in some countries, management and employees in those countries need to be supported to ensure all such payments are reported to senior executives and to the Board, and the means developed to eliminate them completely over time.

Gifts, hospitality and donations

- 4.56 The Company policy on gifts and hospitality (part of "Integrity in Business Dealings") sets out clear corporate principles and standards regarding bribery, the giving and receiving of gifts and hospitality, and on conflicts of interest (it also includes the policy on prohibition of facilitation payments). There are appropriate limits on the value of gifts and hospitality that may be given or accepted, a clear process for senior executive approval in cases where these might be exceeded, and requirements for each business unit (or equivalent) to establish and maintain registers containing details of all gifts and hospitality offered or received. The policy explicitly recognises that the laws and regulations in some countries may differ from the standards set out in the corporate policy and provides that in such circumstances the higher standard shall be applied. As such, the policy and procedures comply with the standards the Committee would expect to find in place, as a minimum, in a global defence company.
- 4.57 This policy is currently under review. This provides an opportunity to improve the way in which information is collected and monitored, to ensure that, in addition to individual transactions, there is oversight on the aggregate spend on individuals and customers as an additional check on overall proportionality. The present system of registering gifts and hospitality does not enable the collection of such aggregate information. The review also provides an opportunity to ensure that the Company's policy is clearly understood by third parties, such as contractors and suppliers, and also customer governments. It is important the Company reaches a clear understanding with all its main customer governments of both the detailed rules that apply and the expectations of what is deemed acceptable. Where possible this agreement should be documented and provided to employees in that country as clear guidance in addition to the global policy and procedures.
- 4.58 There is currently no global policy on corporate donations, although there are plans for this to be addressed. This is an area where a global policy is required and one that must be consistent with the standards in the global code. An explicit assessment of ethical and reputational risks must be a key

element of any decision to make a corporate donation, as must a requirement to be open and transparent about all donations made.

Recommendation 14

The Company should implement central registers (by individual country) to enable information to be collected and monitored on aggregate spend on gifts and hospitality to individuals and overall to each customer. Aggregate spend by individual country on gifts and hospitality should be reported annually to the CRC. The policy on gifts and hospitality should be circulated to customers, contractors and suppliers and the Company should agree and document acceptable standards and expectations of behaviour with each customer government. A global policy on corporate donations should be developed, consistent with the global code and the policy of openness and transparency.

Acquisitions, joint ventures and contractors

- 4.59 The Company, as is the case in other major defence companies, has grown through acquisitions of other companies and has a range of joint ventures and a large number of contractors. The manner in which any of these activities are conducted can expose the Company to ethical and reputational risks. A global defence company will often be in a dominant position and able to influence the ethical business conduct of these activities. This can be achieved by the rapid implementation of its standards in an acquired company (for which the Company's US business has established a strong track record), through its influence, controlling or otherwise in a joint venture, and as a requirement of its key contractors.
- 4.60 The Company's "Integrity in Business Dealings" sets out how it aims to encourage the standards reflected in the key ethical policies (advisers, gifts and hospitality) in joint ventures where it does not have a controlling interest and in other business partners and key contractors. The Company should adopt a more explicit and proactive approach to ensuring the Company's global standards, or equivalent, are in place in these business relationships. Over time, the impact of such a programme should form part of both the internal and external audits of ethical business conduct and the management of reputational risk.

Recommendation 15

The Company should:

- **for all new majority joint ventures require the adoption of its global code and associated policies and procedures, or equivalent standards;**
- **for all new minority joint ventures, mergers and acquisitions, undertake a due diligence assessment of standards of ethical business conduct compared to those of the Company, and ensure to the extent possible that equivalent standards are put in place;**
- **for all new key contractors, require the adoption of its global code and associated policies and procedures, or equivalent standards in all of its collaborative activities; and**
- **for all existing relationships, implement a programme to achieve the above.**

Employee ethics helpline

- 4.61 The Company, in line with practice adopted by many global companies, has established a facility for any employee to raise ethical concerns confidentially and receive advice and guidance independent of their line management. Separate helplines exist for employees in the US business and for employees in the UK

and other businesses. Follow-ups of reports made to the helplines are through the HR Director in the US and the Audit Director in the UK and elsewhere and coordinated and monitored by an Ethics Committee of senior executives. The Board Audit and CR Committees review regular reports on the helpline. The publication, “Ethics and You”, provides clear and user-friendly guidance on using the helpline; an explanation of what happens to concerns raised; and explicit reassurance that employees raising concerns will be supported and not penalised.

- 4.62 The provision of the means for all employees to raise ethical concerns with confidence outside the management line is an important element in any programme to ensure ethical business conduct in a global company. However, the sign of an open, healthy ethical organisational culture is when ethical concerns can be raised, discussed and resolved in line with the Company’s values, principles and standards within the workplace and the management line. Drawing any conclusions, positive or negative, from telephone call volumes is therefore fraught with difficulty. What is important is that the facility exists for all employees; it is well-publicised; employees are confident concerns raised will be properly treated; and it is subject to regular review against external good practice. The Committee has observed that this is the case within the Company.
- 4.63 One development that has been adopted by some global companies is the extension of access to the helpline to certain key third parties associated with the company, (for example customers, advisers, employees in joint ventures and key contractors). This could be developed alongside the programme we recommend (15) above to ensure that the Company’s global standards, or equivalent, are in place within these business relationships.

Recommendation 16

As part of the programme to ensure that equivalent standards are in place for joint ventures and with key contractors, the Company should extend to them appropriate access to its ethics helpline.

Government relations and lobbying

- 4.64 The Company, as any global company, needs to ensure it communicates messages and advances arguments in support of its competitive position at the political level. The methods used to achieve this in each of the countries where the Company has operations should be subject to its corporate ethical values principles, policies and procedures (e.g. on gifts and hospitality), and the laws and regulations that may apply in that particular country (for example the US has regulations requiring registration and extensive reporting of contacts with officials and politicians).
- 4.65 These activities of the Company in the UK have attracted criticism. A number of external interested parties raised concerns in their representations to the Committee. These concerned:
- the level of influence the Company appears to wield;
 - the substance of some of the policy issues the Company has sought to pursue; and
 - the way in which the Company, or those associated with it, have sought to advance their cause.
- 4.66 It is only the latter two instances that fall within the remit of the Committee. The advancing of a particular argument at the political level should always be consistent with the values and standards in the global code; this should be explicitly assessed as part of the internal decision-making process and subject to oversight by the CRC.
- 4.67 The way in which the Company, or those associated with it, conduct government relations is subject to the Company’s ethical principles and policies. Importantly, the process in place for the selection,

appointment and management of advisers includes those contracted to assist the Company in its government relations and lobbying activities.

Recommendation 17

The Company should ensure an explicit assessment of proposed lobbying positions or campaigns against the values and standards in the global code, and that regular reports on this are submitted to the CRC.

Investigation and disciplinary procedures

- 4.68 The Company has policies and procedures in place to ensure an investigation outside of the management line is undertaken and, where appropriate, disciplinary measures are taken for unethical behaviour by employees. The number and cases of dismissals for unethical behaviour are recorded centrally and reported annually to the CRC. This data is published in the Company's annual CR Report.
- 4.69 The Company should consider whether it can be more explicit in demonstrating its robust approach to allegations of unethical behaviour. From an internal perspective this can play a critical role in reinforcing the importance and seriousness the Company attaches to high standards of ethical business conduct, reassure employees that misconduct is not tolerated and that appropriate action will be taken in respect of those who act unethically. Externally, this provides interested parties with confidence that when things do go wrong, the Company will take action including, where appropriate, the voluntary disclosure to the relevant authorities of what has happened.

Recommendation 18

The Company should make explicit its commitment to take a proactive approach to instigating internal investigations into allegations of unethical behaviour and to the disclosure of any material findings to the relevant authorities. Aggregate information on disciplinary actions for unethical behaviour should be included in internal and external publications.

Security division

- 4.70 The Company's Security Division, reporting to the Group HR Director, is responsible for ensuring the safety and security of employees, property and IT systems. Such a function is essential for a global company. However, criticisms have been made over the activities of third parties contracted to provide the Division with information about pressure groups¹⁴. The Company now has a clear and explicit policy to collect only public source information and for strict due diligence to be undertaken of any third party contracted to assist in this. This must be extended to match the process now applied to advisers and oversight of the Security Division formalised through regular reports to the CRC.

Recommendation 19

Any proposals for the appointment of third parties to provide the Company's Security Division with information should be subject to the same process (including Panel review) as for advisers. Regular reports on the activities of the Security Division, and compliance with ethical policies and procedures, should be provided to the CRC.

Training

- 4.71 The implementation and embedding of high standards of ethical business conduct in the culture of any company will depend critically on the quality and reach of the training and guidance provided. This is an area where significant resources must be invested to ensure a sustained and high quality

¹⁴ *Campaign Against the Arms Trade v. BAE Systems plc*, Case No IHQ07/0049.

programme is in place. That programme should be carefully monitored as part of internal and external assurance. The Company already has a range of ethics training across its businesses and every employee should already receive some form of basic awareness training, irrespective of their position or location.

- 4.72 The Company's US business has a mature and mandatory suite of ethics training modules, derived from its code of conduct and which, in part, are a reflection of the compliance requirements placed on all companies operating in the US. An ethics training DVD and provision of the code of conduct form part of the induction process for all new employees. This is followed-up with an online ethics awareness training module. The ethics training-needs of existing employees are identified through a job evaluation questionnaire which then prescribes which of the training modules are to be completed and this is then monitored.
- 4.73 The Company's UK and other businesses developed a similar online and DVD ethics awareness training module in 2005 for all employees and this has been distributed across all of its businesses and translated into Arabic, German and Swedish. All of the Company's senior managers (6,200), and all external facing employees, are also meant to undertake the face-to-face training in the policies and procedures that are contained in "Integrity in Business Dealings". This is intended to take place every two years and form part of the operational assurance statement. However, it appears that the current paper-based method of monitoring may not be sufficient to provide the necessary assurance that this is fully complied with.
- 4.74 The Company has recognised that the successful implementation and embedding of the proposed global code will require building upon these current requirements and the development, delivery and monitoring of a common company-wide system of ethics training. Work is underway on the design of this programme which is to be implemented following the publication of the global code.
- 4.75 The successful delivery of high quality training based upon the global code is critical. This will require the training programme to reach every single employee and should include elements that apply to advisers and other third parties associated with the Company. To be fully effective it will require an element of face-to-face training by managers of every employee in addition to online and other methods. This will require a tailored programme for senior executives and business leaders to equip them to be able to translate and communicate what these standards mean in practice in their parts of the business, varied as this may be in terms of activity, geography and cultural environment. Such a programme, implemented properly, will involve a significant cost and time commitment.

Recommendation 20

A well-resourced training programme, in which every person in the Company participates, should be undertaken as part of the implementation of the global code and revised and repeated at regular intervals. Specific training modules should also be developed for senior executives and business unit leaders. Systems for monitoring these programmes should be developed so that they are able to provide the necessary assurance to the CRC as to their effectiveness.

Leadership in collective action by the defence industry

- 4.76 In Section 2 some examples of collective action by global companies to address ethical issues that had caused reputational damage were highlighted (for example the Kimberley process to stem the flow of conflict diamonds (para 2.15)). In Section 3 issues relating to the defence industry that might benefit from similar collective action promoted by the main global defence companies (para 3.54). The Company is active in external activities relating to the promotion of high standards of ethical conduct

in the defence industry. It is recognised as a proactive member of the DII¹⁵ in the US and took a central role in the European ASD Ethics Task Force that developed the recent Common Industry standards on integrity practices¹⁶.

- 4.77 Many of the external interested parties the Committee consulted during our Review believe, however, that as the prime UK global defence company, the Company must take a more proactive and leadership role in its engagement with the defence industry, governments, NGOs and others to develop initiatives that will address ethical and reputational issues affecting the industry.
- 4.78 The Committee agrees, and believes such an approach would bring considerable benefits to the Company. It would be tangible external evidence of its commitment to high ethical standards as well as providing wider benefits to the defence industry globally. This will require the Company to develop a programme of engagement with external bodies that should include those who may object to some of the Company's activities. It will also require a willingness by the Company to become involved in initiatives that go beyond "supply side" risks in business conduct and attempt to tackle some of the key characteristics of defence contracting that lie behind key ethical and reputational risks. The Company could, for example, support and promote a forum of similar membership to the Roundtable Seminar¹⁷ held as part of this Review.

Recommendation 21

The Company should take a more proactive leadership role in its engagement with the defence industry, governments, NGOs and other external interest parties to develop initiatives that will address the key ethical and reputational issues affecting the defence industry.

Communication

- 4.79 Openness and transparency is the key underlying principle of ethical business conduct and the Company should use this to be an advocate of its own ethical standards. From a wider reputational perspective the same should apply to the Company's internal and external communication about all of its activities. One broad and negative consequence of the media environment surrounding the Company over recent years, and the constraints placed upon it by ongoing investigations and requirements of confidentiality and national security, is that the Company has appeared defensive, lacking in openness and unwilling to explain itself when criticised or challenged.
- 4.80 Any actions the Company takes to ensure the highest standards of ethical conduct in the way it conducts its activities, combined with this Report and the response to it, offers the opportunity to take a more proactive and open approach to explaining all of its activities going forward. The Company can then be confidently more transparent and open in communicating internally and externally about its activities and the ethical standards it applies.

Recommendation 22

The Company should be as open and transparent as possible in communicating all of its activities. Where this is not possible the Company should explain the reasons why.

¹⁵ US Defence Industry Initiative on Business Ethics and Integrity (DII).

¹⁶ European Aerospace and Defence Industries Association (ASD).

¹⁷ Appendix H.

Assurance and reporting

- 4.81 Implementing the measures recommend in this Report and achieving the aspiration to become a leader among global companies will be a challenge for the Company that will require sustained effort over the next few years and continuous focus thereafter. The CRC, internal audit and compliance functions, will play a critical role in developing the methodology by which assurance can be given that these measures are being implemented and followed in practice globally across the Company. It should be recognised that the development of the audit of ethical and reputational risks is in its infancy across global companies when compared to the audit of financial risk. This is an area where if the recommendations are fully implemented the Company will be operating at the leading edge. The Company's global code and key ethical policies and procedures will provide the basis on which metrics for such audits can take place. These will need to be developed alongside the capability and capacity of internal audit to perform this enhanced role. The CRC will need to oversee this development. The medium-term goal must be to achieve a level of audit of ethical and reputational risks that matches that of financial risk.
- 4.82 In reputational terms, demonstrating externally that this has been achieved will be as significant as doing it. Just as with the management of financial and operational risks, there must be an independent external review and validation of the management of ethical and reputational risks, and public reporting of this by the Board. This does not imply removing any responsibility from the CRC and the Board for providing independent assurance of the management of reputational risk through high standards of ethical business conduct. Under the CRC's oversight it will provide critical external and public validation of progress. As with internal audit, this in itself will place the Company at the leading edge of good practice. Together, the internal and external audit will provide the basis for the Board to report publicly and provide assurance of its management of ethical and reputational risks. This should be reported upon in both the CR and Company Annual Reports. The aim, over time, should be for a standard of reporting on ethical and reputational risks that is comparable to that for financial risk.

Recommendation 23

The Board/CR Committee should commission and publish an independent external audit of ethical business conduct and the management of reputational risk in the Company within three years and at regular intervals thereafter.

SECTION 5

Overall assessment

- 5.1 This Review takes place against the backdrop of criticisms made against BAE Systems plc (the Company) in the media, and investigations undertaken by the SFO and others, relating to allegations of bribery and corruption in connection with the award of defence equipment contracts in a number of countries. The Company has always maintained that it does not believe that it has done anything that would constitute a criminal offence. Some criticisms relate to events over 15 years ago. Since that time the Company has changed radically. In less than 10 years it has grown from a predominantly UK-based defence company, heavily dependent on export contracts, into one of the prime global defence companies¹. Over this period the expectations of standards of ethical business conduct, particularly for global companies, have risen sharply and continues to increase and evolve.
- 5.2 The Terms of Reference² for this Review require the Committee publicly report on the Company's existing policies and processes relating to ethical business conduct and, where we believe it necessary, to make recommendations for improvements. As such, the focus is clearly on the present and future ethical business conduct of the Company.
- 5.3 Nevertheless, if the Review is to be meaningful and useful, it is clear that an understanding of the general nature of allegations made and of the reputational impact on the Company they have had (and continue to have) is required. This is necessary, first, to help understand where the Company is starting from in terms of its reputation and perceptions of its ethical business conduct; and second, to ensure that policies and processes are in place to reduce, as far as is practicable the risk of such allegations being made in the future.
- 5.4 The allegations have caused, and continue to cause, reputational damage and cast a shadow of suspicion and doubt over the Company's ethical business conduct and its approach to doing business. This is the reality which the Company has to contend, notwithstanding strong performance in the financial and operational aspects of its business.
- 5.5 The Company is not alone among global companies in having to face allegations of ethical malpractice that cause ongoing reputational damage.
- 5.6 In the global economy, corporate reputation has become an essential part of an enterprise's value and the effective management of ethical and reputational risks is a critical element of corporate governance. Reputational damage may not affect business performance in terms of growth, profitability and market valuation in the very short term; but uncorrected will inevitably undermine overall performance over the medium to longer term, not least through potentially severe distraction of senior management, the risk

¹ A summary of the Company's recent history, structure, performance and a list of countries about which allegations have been made in the media is at Appendix E.

² The Committee's Terms of Reference are at Appendix A.

of litigation, and impact on internal morale. High standards of ethical business conduct, and demonstrating such standards are being met, have become requirements for companies in any sector wishing to operate globally.

- 5.7 Governments clearly have a role in encouraging and facilitating high standards of ethical business conduct, and it is in their interest to do so. In the UK, a long overdue reform of the UK's law on bribery would provide companies with much needed clarity and help repair the UK's international reputation in this area, as well as the reputation and competitiveness of our global companies. The Government should quickly bring forward the necessary legislative proposals to implement the results of the Law Commission's recent consultation³.
- 5.8 In the defence industry in particular, the MoD should expand on its work with defence companies to tackle the ethical and reputational risks that arise through the interaction with the government as a major customer. The transfer of responsibility to promote defence equipment exports from the Ministry of Defence (MoD) to UK Trade and Investment⁴ offers an opportunity that should now be taken for the development of a proactive programme to encourage the adoption of high standards of ethical conduct by all defence companies wishing to export, in particular in those areas of key ethical risk relating to bribery and corruption. Any global defence company aspiring to a high standards of ethical conduct should have in place the necessary policies and procedures and be taking an industry-leading role in initiatives designed to tackle key ethical risks. The five observations the Committee makes in relation to defence companies more generally, and the actions the UK Government could take, are listed at the end of this Section.
- 5.9 It is, however, a core responsibility of companies themselves to meet high standards of ethical conduct, and this responsibility cannot be delegated. Progress has been achieved by the Company over the last five years in this respect. Measures have now been put in place to address the ethical and reputational risks connected with competing for export contracts and further essential work is underway, in particular on the development and implementation of a global code of ethical business conduct and reviews of key areas of ethical risk. On the basis of information provided to the Chairman and Secretary to the Committee, the new contract entered into by the Company in support of the "Salam Project" between the UK and Saudi Governments should not in itself create any risks of unethical conduct by the Company.
- 5.10 But notwithstanding the progress already made, the reputational damage it has sustained, along with the Company's rapid evolution to a global company and the characteristics of the defence sector, mean that more needs to be done. Despite the progress made, the Company has a substantial task ahead if it is to meet higher standards. It needs to raise its sights above that of becoming a leader in its sector to match the benchmarks set by global companies in other sectors.

³ *Reforming Bribery*, Law Commission Consultation Paper no. 185, November 2007.

⁴ On 25 July 2007, the Government announced the transfer of the function for the promotion and support of defence exports from the DESO in the MoD to UK Trade and Investment (UKTI). On 1 April 2008, the UK Trade & Investment Defence & Security Organisation was launched.

- 5.11 To achieve this degree of excellence will require a sustained programme of change with clear and visible personal leadership from the Board and senior executives. The Committee believes from discussions and material examined that this is a view shared by the Board and senior executives that such a programme has begun. The 23 recommendations to the Board, listed at the end of this Section, that the Committee makes are therefore designed to:
- provide material reinforcement of the high level commitment that already exists;
 - help build the robust corporate governance arrangements that are required for the effective management of reputational risk through high standards of ethical business conduct;
 - guide the work already underway, including the development and implementation of a global code of ethical business conduct;
 - help embed a culture of openness and transparency; and
 - strengthen policies and procedures in key areas of ethical risk.
- 5.12 Rigorous implementation of these recommendations should ensure that similar allegations are much less likely to arise in the future. The recommendations for internal and, most importantly, independent external audit of ethical business conduct and the management of reputational risk are designed to provide assurance to the Board, and the public, that this is the case.
- 5.13 The implementation of these will be a considerable challenge for the Company over the next three years. The Committee provides a route map for the Company to establish a global reputation for ethical business conduct that matches its reputation for outstanding technical competence. Taken together with what the Company has already done, this should ensure the continued long-term success of a major UK-based global manufacturing company.

List of recommendations

Aspiration of the Company	<p>Recommendation ①</p> <p>The Board of Directors should decide and communicate the Company's strategic aspiration and intention to be a leader in standards of ethical business conduct among global companies. (page 39)</p>
Openness and transparency	<p>Recommendation ②</p> <p>The Company should be an advocate of its own ethical standards and must adopt the principle of openness and transparency. All ethical business conduct policies and procedures must be publicly available and easily accessible. The Company should be open about the actions it has undertaken to investigate allegations of unethical behaviour and about the outcomes. (page 39)</p>
A global code of ethical business conduct	<p>Recommendation ③</p> <p>The Company should develop, publish and implement a global code of ethical business conduct. The Board should ensure the proposed global code is comprehensive and reflects the high standards of ethical business conduct consistent with the aspiration and intention to become a leader among global companies. (page 41)</p>
Role of the Board of directors	<p>Recommendation ④</p> <p>The Board should develop its increasingly proactive role in ensuring high standards of ethical business conduct in all the Company's activities. It should be a standing item on its agenda. There should be an explicit assessment of ethical and reputational risks in all business decisions taken by the Board. Board members should themselves be exemplars of the standards set out in the global code and receive regular briefings on emerging issues in business ethics. (page 41)</p>
Role of the Corporate Responsibility Committee (CRC)	<p>Recommendation ⑤</p> <p>The Board Corporate Responsibility Committee (CRC) should have primary responsibility for oversight and reporting on standards of ethical business conduct and the management of reputational risk. This role should be performed as the Audit Committee performs its task of managing financial risk. (page 42)</p>
	<p>Recommendation ⑥</p> <p>The Company's Internal Audit function should ensure that ethical business conduct and the management of reputational risk is specifically assessed in all audit reports and the results, and progress made against recommendations, provided to the CRC. The additional skills and resources required for Internal Audit should be provided to achieve this. The CR and Audit Committees should hold at least one joint meeting a year to decide on the preparation of the annual internal audit programme. (page 43)</p>

<p>The role of senior executives</p>	<p>Recommendation 7 Members of the senior executive team and heads of business units have both a personal and collective responsibility to demonstrate high standards of ethical business conduct and to achieve effective implementation of the global code. Both should be reflected in their performance appraisals and in the variable element of their remuneration. <i>(page 43)</i></p>
	<p>Recommendation 8 There should be a senior executive, supported by a sufficiently resourced team, reporting to the CEO and with direct access to the Chair of the CRC, who has responsibility for the programme to ensure and assure there are high standards of ethical business conduct across the Company. <i>(page 44)</i></p>
<p>Decision making within the Company</p>	<p>Recommendation 9 The Company should develop formal processes to ensure business decisions are only taken following an explicit consideration of ethical and reputational risks. Where such risks are identified, the process should ensure any decision to proceed is taken at the appropriate level, and should include ratification by the Board. <i>(page 45)</i></p>
<p>Review of key ethical policies and procedures</p>	<p>Recommendation 10 Policies and procedures in areas of potential ethical risks should be regularly reviewed, with particular attention to the areas of greatest risks. The planned programme of reviews by the Company should ensure a consolidated and comprehensive suite of policies consistent with the global code, providing employees with a clear pathway to understanding how the Company's standards of ethical conduct can be applied in day-to-day business situations. <i>(page 46)</i></p>
<p>Selection, appointment and management of advisers</p>	<p>Recommendation 11 The Company should ensure that the new process for selection, appointment and management of advisers is fully codified and integrated into the mandatory policy and procedures of the operational framework, and that appropriate guidance and training in the process is provided to all relevant employees. This should make explicit:</p> <ul style="list-style-type: none"> • a requirement to undertake face-to-face interviews, involving a company lawyer, as part of the due diligence process with all advisers whose activities require the interaction with potential customers; • a general presumption that the identity of such advisers will be made known to potential customers; and • endorsement by the Board of the adviser panel's recommendations and their explicit approval of any decision to make an appointment contrary to the panel's advice. <i>(page 47)</i>

Offset policy	<p>Recommendation 12</p> <p>Advisers engaged to assist in Offset arrangements in export contracts should be subjected to the same due diligence and approval process as Advisers on the principal export contract. Offset contracts should be subject to a due diligence process requiring an explicit assessment of ethical and reputational risks and be capable of being audited for this. The Company should also be proactive in encouraging greater scrutiny and transparency by governments of the Offset elements of defence contracts. (page 48)</p>
Facilitation payments	<p>Recommendation 13</p> <p>The Company should continue to forbid facilitation payments as a matter of global policy. While it may not be possible to eliminate such payments immediately in some countries, management and employees in those countries need to be supported to ensure all such payments are reported to senior executives and to the Board, and the means developed to eliminate them completely over time. (page 48)</p>
Gifts, hospitality and donations	<p>Recommendation 14</p> <p>The Company should implement central registers (by individual country) to enable information to be collected and monitored on aggregate spend on gifts and hospitality to individuals and overall to each customer. Aggregate spend by individual country on gifts and hospitality should be reported annually to the CRC. The policy on gifts and hospitality should be circulated to customers, contractors and suppliers and the Company should agree and document acceptable standards and expectations of behaviour with each customer government. A global policy on corporate donations should be developed, consistent with the global code and the policy of openness and transparency. (page 49)</p>
Acquisitions, joint ventures and contractors	<p>Recommendation 15</p> <p>The Company should:</p> <ul style="list-style-type: none"> ● for all new majority joint ventures require the adoption of its global code and associated policies and procedures, or equivalent standards; ● for all new minority joint ventures, mergers and acquisitions, undertake a due diligence assessment of standards of ethical business conduct compared to those of the Company, and ensure to the extent possible that equivalent standards are put in place; ● for all new key contractors, require the adoption of its global code and associated policies and procedures, or equivalent standards in all of its collaborative activities; and ● for all existing relationships, implement a programme to achieve the above. (page 49)
Employee ethics line	<p>Recommendation 16</p> <p>As part of the programme to ensure that equivalent standards are in place for joint ventures and with key contractors, the Company should extend to them appropriate access to its ethics helpline. (page 50)</p>

<p>Government relations and lobbying</p>	<p>Recommendation 17 The Company should ensure an explicit assessment of proposed lobbying positions or campaigns against the values and standards in the global code, and that regular reports on this are submitted to the CRC. <i>(page 51)</i></p>
<p>Investigation and disciplinary procedures</p>	<p>Recommendation 18 The Company should make explicit its commitment to take a proactive approach to instigating internal investigations into allegations of unethical behaviour and to the disclosure of any material findings to the relevant authorities. Aggregate information on disciplinary actions for unethical behaviour should be included in internal and external publications. <i>(page 51)</i></p>
<p>Security division</p>	<p>Recommendation 19 Any proposals for the appointment of third parties to provide the Company's Security Division with information should be subject to the same process (including Panel review) as for advisers. Regular reports on the activities of the Security Division, and compliance with ethical policies and procedures, should be provided to the CRC. <i>(page 51)</i></p>
<p>Training</p>	<p>Recommendation 20 A well-resourced training programme, in which every person in the Company participates, should be undertaken as part of the implementation of the global code and revised and repeated at regular intervals. Specific training modules should also be developed for senior executives and business unit leaders. Systems for monitoring these programmes should be developed so that they are able to provide the necessary assurance to the CRC as to their effectiveness. <i>(page 52)</i></p>
<p>Leadership in collective action by the defence industry</p>	<p>Recommendation 21 The Company should take a more proactive leadership role in its engagement with the defence industry, governments, NGOs and other external interest parties to develop initiatives that will address the key ethical and reputational issues affecting the defence industry. <i>(page 53)</i></p>
<p>External communication</p>	<p>Recommendation 22 The Company should be as open and transparent as possible in communicating all of its activities. Where this is not possible the Company should explain the reasons why. <i>(page 53)</i></p>
<p>Assurance and reporting</p>	<p>Recommendation 23 The Board/CR Committee should commission and publish an independent external audit of ethical business conduct and the management of reputational risk in the Company within three years and at regular intervals thereafter. <i>(page 54)</i></p>

List of observations

Global defence companies	Observation ① A global defence company aspiring to high standards of ethical business conduct will have in place policies and procedures, along the lines of those we identify, to effectively manage, audit and report on, the key areas of ethical and reputational risks relating to allegations of bribery and corruption. <i>(page 30)</i>
	Observation ② A global defence company aspiring to high standards of ethical business conduct should take an industry-leading position by actively developing, supporting and promoting initiatives designed to promote greater transparency in export contracts. <i>(page 31)</i>
Role of UK Government: Ministry of Defence	Observation ③ The MoD could expand on its work with the defence industry to review the ethical and reputational risks faced as a result of the interaction between the government and the defence industry. A set of published protocols or a code of conduct could enhance public confidence and trust in both the defence industry and government. <i>(page 32)</i>
Role of UK Government: UK Trade and Investment	Observation ④ The reputation of the UK, and the global competitiveness of UK defence companies, would be enhanced by a proactive programme developed and promoted by UK Trade and Investment to encourage the adoption of high standards of ethical conduct by defence companies wishing to export, in particular, in those areas of key ethical risk relating to bribery and corruption. <i>(page 32)</i>
Reforming UK law on bribery and corruption	Observation ⑤ In light of the results of the consultation on the Law Commission's proposals for Reform of Bribery, the Government should quickly bring forward the necessary legislative proposals. <i>(page 33)</i>

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Appendix A

Terms of Reference

Independent Committee

In forming this Independent Committee to study and publicly report upon its policies and processes, BAE Systems plc (the Company) seeks to:

- a. garner and implement recommendations which enable it to maintain a leadership position in ethical business practice amongst comparable industry peers;
- b. further enhance the publicly available level of assurance regarding the accuracy of its assertions as to its policy, processes and conduct.

Terms of reference and programme of work

The terms of reference for the Independent Committee are as follows:

“The Committee will be formed as an ad hoc committee. Its members will have the background, experience and standing to enable the Committee to perform its work to the highest standards. The Committee will be chaired by one of its members. The Chairmen of the Board’s Audit and Corporate Responsibility Committees will liaise closely with the Committee on behalf of the Board.

The Committee will report to the Chairman of the Company, acting on behalf of the Company’s Board of Directors.

It will review and evaluate the Company’s current (a) policies and processes relating to ethical business conduct generally; (b) internal control procedures; and (c) recordkeeping procedures as each of the foregoing may relate to the Company’s ethical business policy generally and its compliance with applicable anti-corruption legislation, including UK law, the US FCPA and relevant international treaty obligations, in particular. The Committee’s review and evaluation shall include an assessment of the foregoing as currently implemented in practice.”

The Committee may, in the furtherance of its duties, request information from the Company to the extent necessary and/or useful to inform itself, and the Company shall cooperate by providing access to Company documentation and personnel to the maximum extent possible.

Based on its work, the Committee shall reach a judgment as to how the Company’s current policies and procedures benchmark against industry standards, whether they are sufficiently robust to ensure compliance with its ethical business policies generally and in particular to detect and prevent violations of anti-corruption laws.

To the extent the Committee identifies any opportunities for the improvement of the Company’s current policies or procedures as implemented, it shall make recommendations concerning remedial actions or changes in policies and/or procedures that in its judgment the Company should adopt, with particular regard to the ongoing roles of the Board’s Audit and Corporate Responsibility Committees. The Company is committed to measuring its performance in the relevant areas and would welcome recommendations as to appropriate performance measures and measurement techniques that can be applied by the Company in order to ensure that the Committee’s recommendations are implemented appropriately.

The Committee shall be the final judge as to how it performs its duties. It is anticipated that the work may be performed in three stages, as follows:

Phase 1 familiarisation with contract structures typical in the defence sector, the Company’s business and organisation and the collection and review of relevant policies and procedures.

Phase 2 review of the actual implementation of the relevant policies and procedures, including, for example, field testing of the efficacy of the procedures.

Phase 3 formulation of conclusions and recommendations and preparation of a written report.”

Appendix B

About the Committee

Committee members

The Rt Hon The Lord Woolf of Barnes (Chairman)

Lord Woolf was called to the Bar in 1955, and was appointed to the Queen's Bench Division of the High Court of Justice in 1979, a Lord Justice of Appeal in 1986, and a Lord of Appeal in Ordinary in 1992. He was Master of the Rolls (1996-2000) and Lord Chief Justice of England and Wales (2000-2005).

His *Strangeways Report* (HMSO, 1990) and *Access to Justice Report* (HMSO, 1996) were influential on prisons and civil procedure. He chaired the network of the Presidents of the Supreme Judicial Courts of the European Union's Working Group on mediation; conducted a *Review of the Working Methods of the ECHR* (2005-2006); is joint editor of the standard text on administrative law in England, *Judicial Review of Administrative Action* (Sweet and Maxwell, latest edition 2007); has published widely in legal journals; frequently speaks at conferences around the world; and has a number of honorary doctorates.

Lord Woolf is a non-permanent judge of the Court of Final Appeal of Hong Kong; President of the Qatar Financial Centre's Civil and Commercial and Appeal Court; Chairman of the sub-committee of the House of Lords on Parliamentary Standards and a member of the Committee on the Constitution; Chairman of the Bank of England's Financial Market's Law Committee; member of Blackstone Chambers; honorary visiting Professor of the Chinese University of Hong Kong; Visitor to Downing College, University of Cambridge; Honorary Fellow of the British Academy, the Academy of Medical Sciences, University College London, the US College of Trial Lawyers; Honorary Member of the American Law Institute; and President, Chairman and Patron of charities.

Douglas Daft AC

Douglas joined Coca-Cola's Sydney Office in 1969. He subsequently held various positions throughout the Asia

Region, residing in Indonesia, Singapore, Hong Kong and Tokyo. In 1991 he moved to the Company's Atlanta headquarters to assume responsibility for the Asia and Pacific region. Later the Middle East and Africa regions were added. He was appointed President and Chief Operating Officer in 1999 and was elected Chairman of the Board of Directors and Chief Executive Officer of the Coca-Cola Company in 2000, retiring in 2004.

He is currently a director of Wal-Mart Stores, Inc., The McGraw-Hill Companies, and Sistema-Hals; an advisory board member for Longreach, Inc.; Thomas H Lee Partners and Tisbury Capital Management; member of the European Advisory Council for N M Rothschild & Sons Limited; overseer board member for the International Business School of Brandeis University; member of the Board of Governors of Thunderbird, The Garvin School of International Management in Arizona; Chairman of the Advisory Board for the Churchill Archives Center, Churchill College, University of Cambridge; Trustee of the University of Cambridge Foundation; and a Patron of the American Australian Association.

Philippa Foster Back OBE

Philippa worked at Citibank NA before joining Bowater in 1979, where she was later appointed Group Treasurer. She was Group Finance Director at the training organisation DG Gardner Group, and Group Treasurer at Thorn EMI (1993-2000). In 2001 she was appointed Director of the Institute of Business Ethics.

She was a member of the Defence Management Board and chaired the Defence Audit Committee at the Ministry of Defence, but finished her term of office there before joining the Woolf Committee. She was awarded the OBE in January 2006 for services to the Ministry of Defence. Philippa has a number of external appointments including as a non-executive director of the Institute of Directors; a Commissioner of the Public Works Loan Board; and Chairman of the UK Antarctic Heritage Trust. She is a Past President of the Association of Corporate Treasurers.

Sir David Walker

Sir David was Chairman of Morgan Stanley International with executive responsibility for the firm's activities in Europe, the Middle East and Africa (1994-2000 and 2004-2005).

Sir David began his career with the British Treasury in 1961; he was Executive Director for finance and industry at the Bank of England (1980-1988); Chairman of the Securities and Investments Board (1988-1992); Chairman of the International Organisation of Securities Commissions (1991-1992); Member of the Court of the Bank of England, 1981-1993) Deputy Chairman of Lloyds TSB (1992-1994); a non-executive board member of the former CEGB and subsequently of National Power plc (1984-1994); a non-executive board member of Reuters (1994-2000); Chairman of the London Investment Bankers' Association (2001-2003); and Chairman of an independent industry working group on disclosure in the private equity industry (2007).

He is Senior Adviser, Morgan Stanley International; Vice-Chairman of the Legal and General Group; Co-Chairman, University of Cambridge 800th Anniversary Campaign; Chairman of Sofius Capital; a member of the Group of Thirty; Honorary Fellow of Queens' College, University of Cambridge and the Cicely Saunders Foundation and Ambassador for the charity 'Community Links'.

Secretariat

Dr Richard Jarvis, Secretary to the Committee

Richard was previously Secretary to the Committee on Standards in Public Life, the independent advisory Committee on public service ethics. He was seconded to the Woolf Committee from the Cabinet Office.

Anju Still, Executive Assistant

Anju previously worked for the General Council of the Bar as the Personal Assistant to the Complaints Commissioner.

Christopher Campbell-Holt, Researcher

Christopher was seconded part-time to the Woolf Committee from the law firm Norton Rose LLP.

Support provided to the Committee and Secretariat

Advice and assistance to the Committee and Secretariat for the Review was provided by:

- James Eadie QC, Blackstone Chambers, legal counsel;
- Michael Smyth, Head of Public Policy, Clifford Chance LLP, legal advice;
- Rory Godson & Matthew Fletcher, Powerscourt Media, public relations;
- Lord Watson of Richmond, advice on communications;
- Yael Weisberg, Media Link, website and IT support;
- Robert Walton, Technology Moves, IT hardware support; and
- Phillip Lyndon, Column Communications Ltd, graphic design.

Expenditure

The estimated gross expenditure of the Committee on the Review from August 2007 to the end of April 2008 is £1,700,000. This includes all costs associated with office rental, fittings and IT support, Committee members' fees, staff, administration, professional services, seminars, meetings, travel, printing, publishing and distributing this Report.

Appendix C

Approach taken to the Review

The purpose and scope of the Review

The Committee, established by the Board of BAE Systems plc (the Company), was required to give an independent and public assessment of the current and future ethical business practices of the Company, with reference to wider industry standards, and to make recommendations for any action it believed the Company should take¹. The Committee's task was not to conduct an inquiry into the truth or otherwise of the criticism of past conduct of the Company some of which have been, and are currently, subject of investigation by the SFO and others. This did not however preclude the Committee from taking into account the general nature of the allegations in reaching an assessment on the efficacy or otherwise of current and future policies and practices.

Taken together this required the Committee to seek information from and meet with a wide range of sources, both external and internal to the Company as well as commissioning its own independent supporting research.

The Committee began its work on 3 August 2007 following the appointment of Douglas Daft as the final member of the Committee and of Richard Jarvis as Secretary to the Committee.

The Committee focused its work in four main areas²:

- an assessment of ethical policies and practice among major corporations operating in similar business environments to the Company;
- an understanding of the 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 – within which the Company operates;

- an examination of the Company's current ethical policies and processes; and
- an assessment of the Company's current implementation of ethical policies and processes and its adherence to anti-corruption obligations in practice; and how that implementation is monitored to ensure its internal system is adequate to prevent or detect violations.

A number of steps were taken to ensure the Committee's independence in its day-to-day work:

- the Committee had its own offices, separate from the Company and with appropriate security;
- a secure and independent IT system was installed;
- independent legal counsel was retained;
- care was taken to ensure that other individuals and companies retained to support the Committee had no conflicts of interest; and
- Members of the Committee served in an individual rather than in any representational capacity.

The Review process

The Committee's work is evidenced based. Where conclusions are reached and recommendations made they are on the basis of an analysis of information received and generated during the Review. Information for the Review has come from four main sources, external and internal to the Company: written submissions and requested material, meetings with relevant individuals and organisations; specifically commissioned research; and publically available materials. In addition Committee members drew upon their own experience and knowledge. Such is the nature of the Review that some material and briefings, both external and internal to the Company, was provided in confidence to the Committee, and this has been respected. A full list of all those individuals and organisations that provided information is at Appendix D.

¹ Terms of Reference are at Appendix A

² Woolf Committee Press Notice, 3 August 2007

Committee meetings

The Committee met regularly throughout the duration of the Review at its offices in 16 Old Queen Street, London, SW1H 9HP. All significant issues were discussed and agreed collectively by the Committee at these meetings. Where it was necessary for decisions to be taken outside of formal Committee meetings, the views of Committee members were sought by the Secretary and conveyed to the Chairman, Lord Woolf.

Written submissions and meetings with external interested parties

On 3 August 2007 the Committee announced its intention to seek views and submissions on issues relevant to its terms of reference and on main work areas, from external interested parties and from employees of the Company.

Lord Woolf wrote directly to over 100 external individuals and organisations inviting written submissions on issues relevant to the Committee's terms of reference and the four main areas of work. As a result the Committee received a further 31 submissions. The Committee then held over 30 meetings with some of these external individuals and organisations to explore points raised in their submissions and additional points relevant to the terms of reference.

Full lists of who the Committee contacted, received submissions from, and met with are in Appendix D.

Commissioned research

The Committee decided to commission two specific pieces of supporting research to help inform their consideration of the four main works areas.

The first piece of research was undertaken by Simon Webley and Andrea Werner of Institute of Business Ethics (IBE) who analysed information published on ethical business conduct by twelve global companies from a number of different sectors based in the UK, US and Continental Europe, including BAE Systems plc. The second phase analysed responses provided in confidence from a selection of six companies from the original sample, to five specific questions concerning the implementation of particular ethical policies, and how the overall effectiveness of their ethical policies overall is assessed. A third phase summarised a selection of external, international business ethics standards. The results of all three phases of this research can be found at Appendix F.

The second piece of research was conducted by Dr Andrew Dorman, Professor Sir Lawrence Freedman and Professor Matt Uttley from the Department of War Studies, King's College London. The research assessed the strategic and political context in which defence contractors have to operate with the aim of identifying the moral hazards that create potential ethical dilemmas. The report "Pitfalls of the defence industry" can be found at Appendix G.

Roundtable seminar

In order for the Committee to benefit from wider discussion of the issues raised in the two pieces of research, it promoted a Roundtable Seminar held at the Royal Horseguards Hotel, London, on the afternoon of Wednesday 6 February. The Seminar was hosted by Professor Sir Lawrence Freedman, King's College London and chaired by Lord Robertson of Port Ellen, former Secretary General of NATO. It was attended by senior representatives from governments, academia, industry (including the Company), and NGOs.

The aim of the Seminar was to generate informed discussion and debate on the ethical business practices expected from a global company; and the application of these practices in the defence industry, particularly in key areas of ethical risk, and the role Governments and others can play. There was debate and discussion on these issues following presentations on the research commissioned by the Committee. The discussion was held under Chatham House Rules with a non-attributable summary prepared by King's College London. This and a list of seminar attendees can be found at Appendix H.

Internal Company Documentation and Interviews

In order to undertake the assessment of the Company's ethical policies and procedures the Committee requested and examined a large volume of internal Company documentation. They included reviews of:

- the background and history of the Company, its evolving strategy, organisation, corporate governance and business planning, assurance and decision making frameworks;
- the ethical policies, processes, guidance, training and communication programmes. Results from employee ethics surveys and the employee ethics helpline;
- the policies and procedures relating to exports, including the selection of markets, the selection, appointment and management of advisers, export controls and Offsets;

- the audit processes, including internal audit reports on key areas of ethical risk and minutes of the Board and Executive Audit Committees;
- the internal and external communications on reputational and ethical issues;
- the policies and procedures relating to governmental relations;
- the Minutes of the Board and Corporate Responsibility Committee (CRC) meetings; and
- commercial information (provided to the Chairman and Secretary of the Committee) about the contract the Company entered into in October 2007 with the UK Government relating to the agreement between the governments of the UK and the Kingdom of Saudi Arabia, known as the Salam Project.

The Committee also held interviews and briefing sessions with a wide range of personnel at all levels within the Company, including, the Chairman, members of the Board, the Chief Executive Officer (CEO) and members of the Executive Committee, senior executives with responsibility for key policies and processes in areas of ethical risk and national trade union representatives. Committee members visited BAE Systems Inc. in Washington US and met with the Board and senior executives and some US-based external interested parties. Members of the Committee also visited the Company sites in Warton and Barrow-in-Furness in the UK where private discussions were held with groups representing a cross-section of employees, local trade union representatives, apprentices and graduates intake.

A list of all those individuals from the Company who the Committee interviewed and received briefings from and list of internal Company documentation reviewed by the Committee can be found at Appendix D.

Submission from company employees

The Committee's 4 August announcement was sent to all of the Company's employees by email with a message from Lord Woolf encouraging employees to submit their views and suggestions using the secure and confidential facility set-up on the Committee's website. It was further publicised through an article in the Company's main internal newspaper. As a result 44 submissions were received through the secure website facility.

Preparation of the Report and recommendations

This Report and recommendations were published at the same time as they were presented to the Board of the Company. Neither the final Report nor drafts of it

were presented to, or subject to comment from, the Board prior to publication.

Acknowledgements

The Committee would like to record its thanks to those, both internal and external to the Company, who took the time and trouble to make written submissions and/or to meet with Committee. We were fortunate to receive information from a wide range of well-informed sources whose experience and insights have proved extremely valuable. All our requests to the Company for materials and interviews were met. We would like to thank Martha LaCrosse, Head of Chairman's Office, in particular, for her assistance in ensuring that all our requests were met

Appendix D

List of meetings and materials reviewed

D-1 Members of the Committee held meetings with the following either individually or in groups, who are external to BAE Systems plc.

Margaret Aldred, Deputy Head, Defence & Overseas Secretariat, Cabinet Office

David Allwood, Head of Business Principles Unit, Export and Credit Guarantee Department

Daniel Altman, Director of Operations, AFOSI Detachment 515, US Air Force

Conrad Bailey, Director of Defence Acquisition, Ministry of Defence

Dr Robert Barrington, Director of Governance & Sustainable Investment, Foreign & Colonial Asset Management

Tania Baumann, Policy Manager, International Chamber of Commerce United Kingdom

Richard Bednar, Coordinator, Defense Industry Initiative on Business Ethics and Conduct (DII); Senior Counsel, Crowell & Moring LLP

Sir Brian Bender KCB, Permanent Secretary, Department of Business Enterprise and Better Regulation

Andrew Cahn, Chief Executive, UK Trade & Investment

Neil Capp, Legal Advisor, Export Control Organisation, Department of Business Enterprise and Better Regulation

Jayne Carpenter, Head of Policy, Export Control Organisation, Department of Business Enterprise and Better Regulation

Sir Suma Chakrabarti KCB, Permanent Secretary, Department for International Development (to 11.07)

Laurence Cockcroft, Chairman, Transparency International UK

Patrick Crawford, Chief Executive, Export and Credit Guarantee Department

Jonathan Cummins, Defence Analyst, Foreign & Colonial Asset Management

John Doddrell, Director Export Control Organisation, Export Control Organisation, Department of Business Enterprise and Better Regulation

Steven Dodgson, Business Group Director, Export and Credit Guarantee Department

Andrew Feinstein, Author, former ANC Member of the Parliament of South Africa

Ann Feltham, Parliamentary Coordinator, Campaign Against the Arms Trade

Dave Fish, Director East and Central Asia, Department for International Development

Simon Foster, Assistant Director of Defence Acquisition, Ministry of Defence

Helen Garlick, Assistant Director, Serious Fraud Office

Alan Garwood, Head of Defence Exports, Defence Export Service Organisation (to 09.07)

François Gayet, Secretary General, Defence Industries Association of Europe

Ian Godden, Chief Executive Officer, Society of British Aerospace Companies

Dr Patricia Harned, President, Ethics Resource Centre (US)

Martin Hemming, Legal Director, Ministry of Defence

Andrew Hope, Director, International Chamber of Commerce United Kingdom

Sir Bill Jeffrey KCB, Permanent Secretary, Ministry of Defence

Dominic Jermey, Managing Director Sector Group, UK Trade & Investment

John Longhurst, Senior Vice-President Capital International Research Inc, Capital International

Derek Marshall, Director of Aerospace, Defence and Homeland Security Society of British Aerospace Companies

Sir Mark Moody-Stuart, Chair, Anglo American plc (Member of the UN Secretary General's Advisory Council for the Global Compact)

Sir Gus O'Donnell KCB, Secretary of the Cabinet and Head of the Home Civil Service

Thomas O'Malley, Investment Analyst Corporate Responsibility, Capital International

Anthony Pawson, Interim Head of Defence Exports, Defence Export Service Organisation (from 09.07)

Professor Mark Pieth, Professor of Criminal Law, University of Basel (Chairman, Working Group on Bribery, Organisation for Economic Cooperation and Development)

Steven Pollard, Director General Saudi Arabia, Ministry of Defence

Ian Pritchard, Research Coordinator, Campaign Against the Arms Trade

Mark Pyman, Project Director, Defence against Corruption, Transparency International UK

Ed Quilty, Director, IT & Finance, UK Trade & Investment

Sir Peter Ricketts KCMG, Permanent Under Secretary, Foreign and Commonwealth Office and Head of Diplomatic Service

Steve Roberts-Mee, Head of Communications, Export and Credit Guarantee Department

Major Alan Sharman CBE, (Retired) Director General, Defence Manufacturing Association (UK)

Steven Shaw, Deputy General Counsel (Contractor Responsibility), US Air Force

Rt Hon Jack Straw MP, Secretary of State for Justice and Lord Chancellor

Air Commodore Alan Waldron, Formerly Head of Operations for the RAF, an Advisor to the Defence against Corruption Project, Transparency International UK

John Wall, General Secretary, Confederation of Ship Building and Engineering Unions

Robert Wardle, Director, Serious Fraud Office

Alexandra Wragg, Director, Trace International Inc

D-2 The following organisations and individuals, external to BAE Systems plc, made written submissions to the Committee¹.

Alliance Growth Equities

Andrew Feinstein, Author and former ANC Member of the Parliament of South Africa

Barclays Global Investors

Bernstein Value Equities

Cabinet Office

Campaign Against the Arms Trade

Confederation of British Industry

Confederation of Ship Building and Engineering Unions

Defence Manufacturers Association (UK)

Export Control Organisation

Export Credits Guarantee Department

Foreign & Colonial Asset Management

GoodCorporation Limited

International Chamber of Commerce United Kingdom

Rt Hon Michael Jack, Member of Parliament, Fylde Legal & General Investment Management Limited

Ian Liddell-Grainger, Member of Parliament, Bridgwater

Major General Alan Sharman, Retired Director General of Defence Manufacturers Association (UK)

Standard Life Investments UK

Rt Hon Jack Straw, Member of Parliament, Blackburn The Corner House

The McGraw-Hill Companies

Rt Hon the Lord Patten of Wincanton

Transparency International UK

UK Defence Forum

David Willetts, Member of Parliament, Havant

D-3 The following organisations and individuals external to BAE Systems plc were contacted directly in writing by the Committee and invited to submit their views on the issues covered by the Review.

Advanced Research and Assessment Group

Alliance Growth Equities

Anglo American plc

Barclays Global Investors

Bernstein Value Equities

BlackRock Merrill Lynch Investment Managers

Cabinet Office

Campaign Against the Arms Trade

Confederation of British Industry

Confederation of Ship Building and Engineering Unions

Control Risks

Defence Export Service Organisation, Ministry of Defence

Defence Industries Association of Europe (EU)

Defence Manufacturers Association (UK)

Defense Industry Initiative (US)

Department for Business Enterprise and Regulatory Reform

Department for International Development

Dow Jones Sustainability Indexes

Ethics Resource Center (US)

Export and Credit Guarantee Department

Fidelity International Limited

Foreign & Colonial Asset Management

Foreign and Commonwealth Office

Franklin Templeton Investment Management Limited

¹ This excludes the 44 submissions made confidentially through the Committee's secure website facility.

GoodCorporation Limited
 H M Treasury
 Hermes Equity Ownership Services
 International Chamber of Commerce United Kingdom
 King's College London, Centre for Defence Studies
 Legal & General Investment Management Limited
 Ministry of Defence
 Organisation for Economic Cooperation and Development
 Royal United Services Institute for Defence and Security Studies
 Saferworld
 SERM Rating Agency Limited
 Standard Life Investments UK
 SustainAbility Limited

The Capital Group of Companies International
 The Corner House
 The Institute of Social and Ethical AccountAbility UK
 The International Institute for Strategic Studies
 The McGraw-Hill Companies
 The Royal Institute of International Affairs
 The Serious Fraud Office
 The Society of British Aerospace Companies
 The UK Defence Forum
 TRACE International Inc
 Transparency International UK
 UK Trade & Investment

45 Members of Parliament where BAE Systems plc is an employer in their constituency

D-4 The Committee also invited submissions from interested parties, including employees of BAE Systems plc that could be made confidentially through the Committee's secure website facility.

44 submissions were received from this source. These can be summarised as follows:

Internal Responses	84%
External Responses	15%
Contact details provided	84%
Contact details not provided	15%

<i>Areas of concerns:</i>	
Committee's Terms of Reference etc	14%
Miscellaneous	8%
Positive comments on the Company	4%
Sponsorship	2%
General Ethical issues	6%
Sales/Marketing/Advisers	22%
Weapons	4%
Human Resources Issues	39%

D-5 Members of the Committee held interviews and briefing with the following individuals from BAE Systems plc

Board Executive Directors

Mike Turner, Chief Executive Officer
 Walt Havenstein, Chief Operating Officer and President and Chief Executive Officer, BAE Systems Inc.
 Ian King, Chief Operating Officer, UK/RoW
 George Rose, Group Finance Director

Haydon Clulow, Operations Director, Submarine Solutions
 David Cole, Finance and Commercial Director, Submarine Solutions
 Tony Burbridge, Future Submarines Director, Submarine Solutions
 John Hudson, Design Authority and Engineering Director, Submarine Solutions
 Nigel Whitehead, Group Managing Director, Military Air Solutions
 Peter Anstiss, Sales and Marketing Director, Military Air Solutions
 Phil Thornber, Commercial Director, Military Air Solutions
 Sheila Cheston, General Counsel, Senior Vice President, BAE Systems Inc
 Robert Fitch, Government Relations, Senior Vice President, BAE Systems Inc

Executive Committee Members

Philip Bramwell, Group General Counsel
 Alan Garwood, Group Business Development Director (from 01.08)
 Alastair Imrie, Group Human Resources Director
 Mike Rouse, Group Marketing Director (to 12.07)

Business Executives

Peter Wilson, Managing Director, Saudi Arabia
 Andrew Guest, Chief Counsel, CS&S International
 Murray Easton, Managing Director, Submarine Solutions

Jeff Cottle, Director International Compliance, BAE Systems Inc
 Charles Chadwick, Director, Vice President Contracts and Business Conduct, BAE Systems Inc

BAE Systems Inc. Non-Executive

Richard Kerr, Member, Board of Directors, BAE Systems, Inc., Chairman of the Government Security Committee

Head Office Executives

Rory Fisher, Managing Director, Centre for Performance Excellence

Grenville Hodge, Audit Director

Deborah Allen, Director, Corporate Responsibility

Martha LaCrosse, Head of Chairman's Office

Charlotte Lambkin, Group Communications Director

Michael McGinty, Head of Security
 David Parks, Company Secretary
 Julian Scopes, Director of Government Relations
 Mark Serfozo, Chief Counsel, Compliance & Regulation

External

Ted Awty, External Auditor – KPMG

John Turnbull, Partner, Linklaters, Chair of BAE UK/RoW Advisors Panel

Roger Witten, Partner, WilmerHale, Chair of BAE Systems Inc Advisors Panel

In addition to the above members of the Committee also attended meetings of the Non-Executive Directors, Executive Committee and Corporate Responsibility Committee.

D-6 The following is a list of internal documentation from BAE Systems plc reviewed by the Committee

Strategy and history

Briefing Document: History from 1981

Example Strategy Reviews

Board Briefing Papers on Group Strategy 2004-7

Company Strategy Communications Material

Example Strategy Communications from CEO

Example Position Paper: Company position on Clusters Munitions

Board

Overview of BAE Systems Approach to the Board and Corporate Governance

Copies of all Board Minutes 2006-2007

Copies of all Board Audit Committee Minutes 2006-7

Copies of all Board CR Committee Minutes 2006-7

Copies of all Group Audit Review Board Minutes 2006-7

BAE Systems Board Charter

Board Committee Charters

Operational Assurance Policy

Operational Assurance Statement Policy

Integrity in business dealings

Advisers Policy – January 2007

Policy for the appointment of Advisers – 2005

Adviser Application Forms

2007 Process for Appointment and Management of Marketing Advisers

2007 Global Adviser Agreement

Panel Guidance Terms for the appointment of Marketing Advisers – UK/RoW

Panel Guidance Terms for the appointment of Marketing Advisers – Inc.

Adviser Agreement: Internal Guidance Notes

Due Diligence Process: Scope of Work for External Providers

All overseas office reviews conducted by Director of International Compliance since 2001

Policy: Gifts, Hospitality and Personal Benefits 2005

Statement of Ethical Business Conduct

Introduction to Business Ethics – Training DVD

Ethics and You – 2002, 2005

Example Ethics Awareness Training Programme

Personal Confirmation of Training Receipt

Internal Communication: Ethics and Principles Poster Campaigns

Gifts and Hospitality process flowcharts

Operational Assurance Register

Ethics Review Committee Terms of Reference

CR Report 2006 and 2007

BAE Inc. Policy on Ethical Business Conduct

BAE Inc. Ethics On-line Training Modules

BAE Inc. Ethics Training and Helpline Statistics

BAE Inc. Ethics Officer Resource Manual

BAE Inc. Submission to Defense Industry Initiative (DII) Public Accountability Report

DII Report on BAE Systems Inc. Business Ethics

BAE Inc. Employee Guidelines on Ethical Conduct

BAE Inc. Policy on the Foreign Corrupt Practices Act

BAE Inc. Policy on the Authorization and Processing of International Representative and Consulting Agreements

BAE Inc. Policy on International Distributors

Personal Development Review: Ethics Assessment

Overview of BAE Inc. Approach to Anti-Corruption

BAE Inc. Adviser application Forms

BAE Inc. FCPA On-Line Training for Advisers
January 2008 Briefing to Senior Leadership:
Development of Group Code of Conduct

Export marketing

Overview of BAE Systems Approach to Defense Exports
Case Study: Export Campaign
BAE Systems Export Finance Function Overview
List of Defense Sales Prospects
Export Market Prioritisation
BAE Systems Integrated Business Planning Process (IBPP)
BAE Systems Lifecycle Management Framework (LCM)
BAE Systems Export Control Policy
Central Marketing Roles and Responsibilities
Business Winning Mandated LCM Processes
The Bid Process
Guide to Bid Status Reviews
Business Winning Handbook for Integrated Campaign
Teams
Summary of Key Export Campaigns

Offset

Overview of BAE Systems Approach to Industrial
Participation (Offset)
UK (DESO) Offset Guidelines to Foreign Bidders
BAE Systems Offset Policy
BAE Systems Offset Handbook
BAE Systems Offset Handbook – Supply Chain Offset
Management
BAE Systems Offset Handbook – Offset Contracting
BAE Systems Process for the Approval of Offset Advisers
BAE Systems Industrial Offset Group – Terms of
Reference
BAE Systems Offset Awareness Course
Geographical Spread of Current Commitments
Current and Forecast Offset Commitments
Assessment of Compliance against Mandated LCM
December 2007 Operational Assurance Returns: Offset
Example Offset Management Plan – Infantry Fighting
Vehicles
Proposal for the Appointment of Offset Adviser – Due
Diligence
Example Offset Agreement

Export control

Overview of BAE Inc. Approach to US Export Control
BAE Inc. US Export / Import Control Policy
BAE Inc. US Empowered Officials Policy
BAE Inc. Protection of US Export Controlled Data
BAE Inc. Export Control Compliance and Procedures
Manual
BAE Inc. Empowered Officials Annual Conference
Agenda
BAE Inc. Employee Export Control Training Register
BAE Inc. Export Control Compliance Review
Questionnaire

Overview of BAE Plc Approach to UK Export Control
BAE Systems Export Control Policy
Description of UK Export Control Regulatory Framework
Operational Assurance Statement Return – 2007 Export
Control
List of UK Export Control Compliance Audits
Example Government Compliance report/audit letters
Example Voluntary Disclosures to Government

Government relations

Overview of BAE Systems Approach to UK Government
Relations
Internal Governance of UK Lobbying
Parliamentary Reception Attendee List – 2006
Trade Union Lobbying Activities: 2006
Trade Union – BAE Systems Forum – 2007
BAE Inc. Approach to Government Lobbying
BAE Inc. Federal Election Commission guidelines on
Political Action Committee Reporting
BAE Systems PAC Disclosure Return

Subscriptions and donations

BAE Systems Subscriptions and Donations Governance
BAE Systems S&D Committee Terms of Reference
BAE Systems S&D Committee Minutes 2006-7

Security

BAE Systems Security Adviser Policy

HR

Overview of BAE Systems Approach to Developing
Leadership
BAE Systems Performance Centered Leadership
“Driving High Performance” Brochure
PCL Development Framework
PCL Behavioural Competencies
Senior Leadership Programme
Information related to dismissals of employees for
breach of company ethical policies

Communications

Overview of BAE Systems Approach to Communication
BAE Systems Communication Policy
BAE Systems Communication Strategy
Internal Communications Tools and Processes
Internal Communications on Ethics
Example CEO Company Notices Related to
Ethics/Reputation
External Communications: Chairman's Speech to
European Ethics Forum January 2008
External Communications: Responses to media on
Ethics-Related queries
External Review of BAE Systems' Reputation – Ipsos
Mori
National News Index Rating and Methodology –
December 2007

Internal audit (IA)

Overview of Audit Function and Processes

IA Charter

IA 2007 Audit Programme

2007 External Quality Assessment of Internal Audit
(Deloitte)

All Internal Audit Reports (2002-7) related to ethics and
reputation:

- Overseas offices

- Integrity in Business Dealings

- Appointment of Advisers

- Subscriptions and Donations

- Gifts and Hospitality

Audit Review Board Papers: Military Air Solutions

Example Report to Board Audit Committee 2007

Example Report to Board CR Committee 2006

Ethics Helpline Report to Board CR Committee

Example OAS reports to Board Audit and CR

Committees August 2007

Benchmark review of Ethics Helpline Effectiveness:

- Report to Board Audit Committee

Remedial actions taken to improve ethics helpline:

- Report to Board CR Committee

2007 Ethics Awareness Survey

Appendix E

Information about BAE Systems plc

Recent history of BAE Systems plc

BAE Systems plc is a public company incorporated in the UK with shares listed on the London Stock Exchange. It was formed in 1999 by the merger between British Aerospace plc and GEC Marconi, both of whom were predominantly UK-based manufacturers with a reliance on exports contracts. The Company includes a large proportion of the UK's aircraft, shipbuilding and electronics industries that developed during the 20th Century. Famous names including Avro, Armstrong Whitworth, Marconi, Vickers, de Havilland and Hawker are part of the Company's heritage.

Based upon a presence established in the US by GEC in defence electronics, and through a series of significant acquisitions of US defence business in 2000, 2003 and 2005, the Company established itself as a major player in the US defence market that has been further consolidated with the acquisition of Armor Holdings. The Company's US business is conducted through its US subsidiary BAE Systems Inc.

Alongside its expansion into the US, the Company rationalised its UK and European businesses and in particular European Joint Ventures, most notably the disposal of its 20% shareholding in Airbus in 2006. In the UK, during 2000-2002 the Company identified significant cost and time overrun problems with two large contracts with the MoD involving the Nimrod maritime patrol aircraft and the Astute nuclear submarines. Changes to the contract structure were subsequently agreed with MoD, but the Company incurred significant costs and suffered reputational damage as a result. Following this, the Company placed a heavy focus on improving the strength of its controls, assessment and assurance of financial and operational risks. The Company remains the biggest supplier of defence equipment to the MoD and this will continue to be the case in the future through the implementation of the DIS¹.

The Company has also been expanding into what it describes as its other "home" markets. It now has significant operations and is a major indigenous supplier of defence equipment to the governments of Australia, the Kingdom of Saudi Arabia, South Africa and Sweden. Part of the Company's forward strategy is to continue to develop all of the six geographical areas that it refers to as "home" markets and to consider establishing a presence in other new "home" markets.

The Company is organised through a combination of business unit leaders responsible for the operation and performance of their respective businesses and functional leaders providing corporate expertise and guidance. The business unit leaders report to two COOs, one for the US led operations and one for the UK and Rest of World (RoW) led operations, both of whom report to the CEO. Functional leaders (including Finance and HR) also report to the CEO. The Group General Counsel has a dual reporting line to the CEO and the Chairman. The two COOs along with the CEO and Finance Director are members of the Board. The Board has 9 non-executive Directors including a non-executive Chairman. An executive committee consisting of 9 members of the senior leadership team, chaired by the CEO, is responsible for developing and delivering the Company's strategy.

Both the non-executive and executive team have seen significant changes in the last four years. Dick Olver, formerly deputy Group Chief Executive of BP plc, was appointed non-executive Chairman in 2004 and since then 6 new non-executive Directors have joined the Board. New COOs for both the US led operations and the UK and RoW led operations have been appointed within the last 18 months, as have a new Group General Counsel and Group Business Development (formerly Marketing) Director. Further change will occur in August 2008 when the CEO, Mike Turner, steps down having led the Company through this period of growth and commercial success.

¹ UK Government's Defence Industrial Strategy, Defence White Paper (HMSO, 2005) Cm 6697.

Company structure

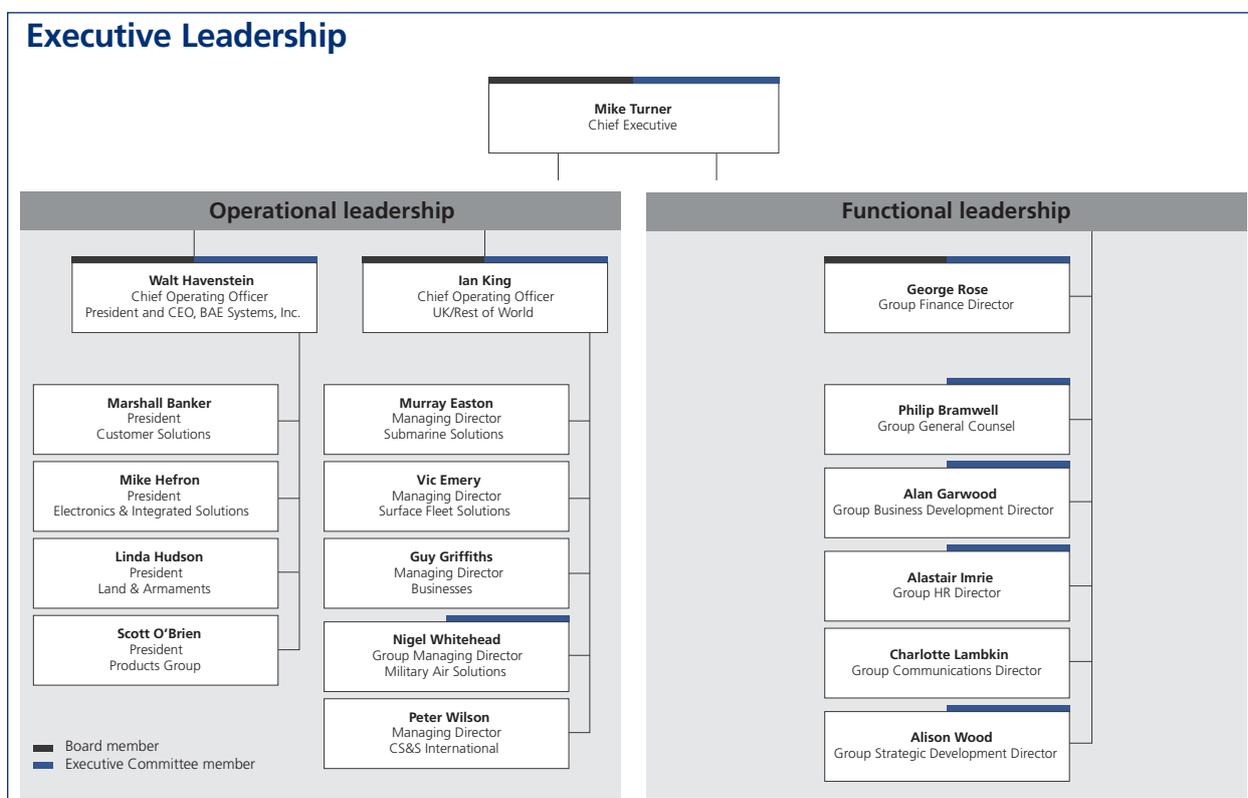
Non-Executive Directors



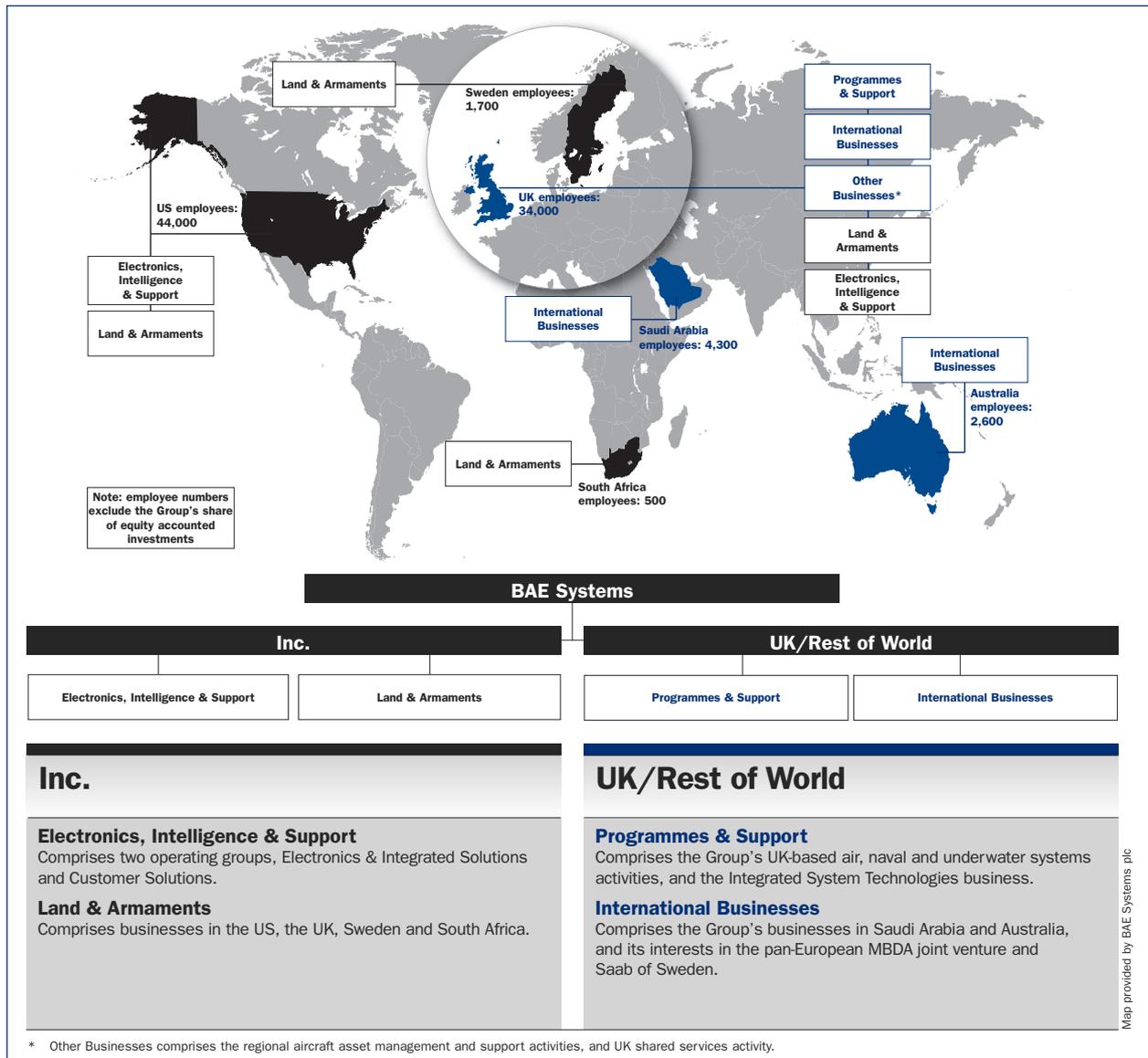
Corporate Responsibility Committee



Executive Leadership



Company operations

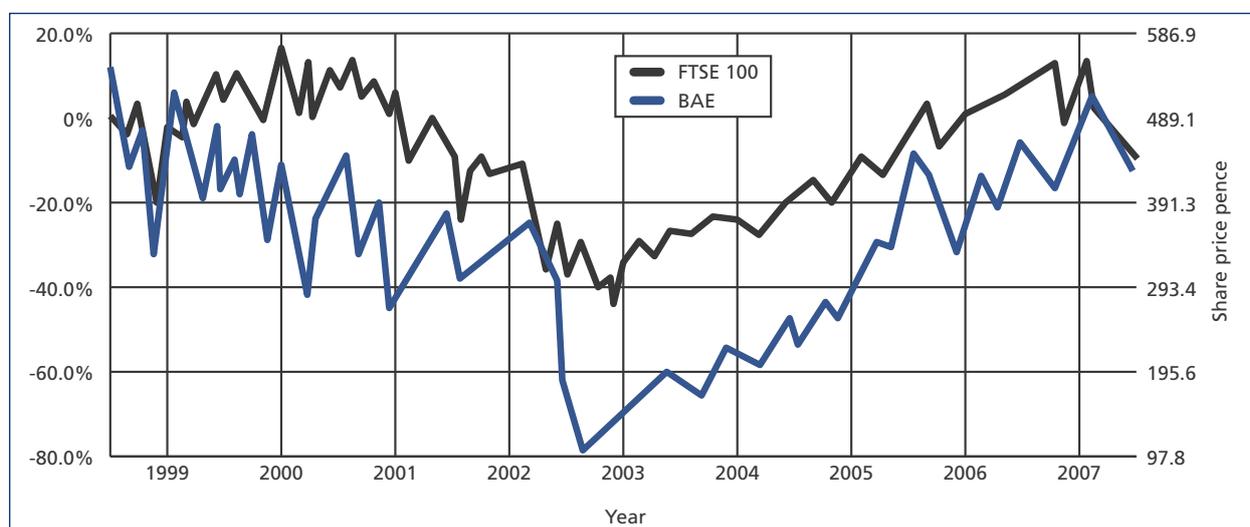


Company Sales² for 2007: £15,710m
 EBITA³ for 2007: £1,477m

² Including share of equity accounted investments

³ Earnings before amortisation and impairment of intangible assets, finance costs and taxation expense

Company share price



List of countries about which allegations have been made in the media regarding the business conduct of BAE Systems plc⁴

- Chile
- Czech Republic
- Hungary
- Qatar
- Romania
- Saudi Arabia
- Slovakia
- South Africa
- Sweden
- Tanzania

⁴ The Committee is grateful to Transparency International UK for providing it with their News Digest of press extracts regarding BAE Systems plc. The list here is not intended to be exhaustive.

Appendix F



Report for Woolf Committee

PART I

Comparisons of Corporate Codes of Ethics and Similar Documents

Prepared by Institute of Business Ethics

Date: 18 December 2007

Simon Webley, Research Director of the Institute of Business Ethics, is responsible for this Report.

Research assistance was provided by Dr Andrea Werner and Sarah Priest.

Institute of Business Ethics
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London SW1P 1BE
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www.ibe.org.uk

Introduction

1. This Report follows the format of the Proposal submitted to the Woolf Committee (WC) on August 6th 2007 and amended in an email from Richard Jarvis (RJ) on August 7th.
2. It compares the stated policies and practices of BAE Systems and eleven large companies regarding corporate values and ethics. All the information in this Report is in the public domain except where indicated.
3. Information from BAE systems came from their websites (UK and US) and from their intranet site provided to us as a Pdf with agreement for IBE to use in this Report.

The Research

1. The information obtained from company searches was classified under five main headings:
 - A. Corporate values
 - B. The purpose of the code
 - C. Implementation of the values and ethics policy
 - D. Relations with governments
 - E. Relations with advisors/agents
2. Headings C and D have a number of subheads covering different aspects of the topic.
3. Sources used for the information were:
 - Company websites on ethics, corporate responsibility etc.
 - Corporate Responsibility Reports (or similar titles)
 - Company Annual Reports
4. Table 1 (not included here, see www.woolfcommittee.com) sets out the data in a form that enables comparisons to be made. In assessing what is publicly available (as opposed to what can be learnt from interviews), it became clear that only two of the specific questions that IBE was asked to examine could be addressed. These were:
 - a. Relations with governments, especially regarding contracts and
 - b. Local national advisors/agents, their recruitment, contracts and accountability.
5. Little if any information could be found in the public domain about:
 - a. The process of acquisitions, especially relating to ethical practices of the company being acquired

and

- b. Decision making (and how and who makes it) regarding walking away from a potential contract, acquisition or joint venture.

6. A short commentary has been provided on each topic highlighting the main features and comparing them with the current practice at BAE Systems. This is reproduced in an Annex at the end of this Report. Just because a policy is not seen to be in the public domain, it does not necessarily mean that it does not exist. Indeed some companies e.g., Boeing, appear to be unusually open on some issues where others are silent. Part II of the work will consist of specific questions to selected companies to elicit information on the topics in paragraph 5.
7. Table 2 ((not included here, see www.woolfcommittee.com) sets out what the selected companies reported to their shareholders and the general public, usually in 2006, regarding the following five aspects of their values and ethics policy:
 - Values and codes
 - Speak-up lines and breaches of the code
 - Training in business ethics
 - Bribery and corruption
 - Key Performance Indicators (KPIs)

Some Conclusions from this Survey

1. BAE System's publicly available information on its corporate values and ethics and their application to business practices is not as detailed as that of many of its competitors or similar sized international companies.
2. The company's 'Ethics and you' statement sets out the main ethical dilemmas that an employee may encounter. It is presented in a 'user friendly' fashion using a question and answer format. However, it is not really a substitute for a corporate code of ethics.
3. Probably due to a strong pressures to comply to newly passed laws and stock Exchange listing standards, BAE's US Board has a more explicit and comprehensive code of ethics.
4. Information reported in BAE's Annual Report, Annual Review and CR Report shed more light on the workings of the policy than is contained in their formal documents.
5. US defence companies seem reticent to report on values policies and practices and BAE (US) is not an exception.

6. An Ethical Assurance Statement by The Corporate Citizenship Company dated 9 March 2007 contained in BAE's Corporate Responsibility Report 2006, draws attention to certain shortcomings in BAE's Report including the lack of information on how crucial decisions are made. A summary is included after Table 2.

ANNEX 1

COMMENTARY ON THE INFORMATION ON VALUES AND ETHICS POLICIES OF SELECTED CORPORATIONS

Those in Table 1 (not included here, see www.woolfcommittee.com)

1. Corporate Values

BAE System's five core values (accountability, honesty, integrity, openness, respect) are the same or similar to those of the benchmark companies. They also reflect IBE's list of the most commonly used ethical value words used in codes. It will be important to know the way that BAE interprets its value words to make them useful, clear and relevant. Indication on how the company approaches this is expected from the questionnaire reply in Part II.

2. Purpose of the Code

Most of the preambles to the corporate codes emphasise that their principal purpose is to provide guidance and help to staff (and in some cases agents, and "people who act for us") in upholding core values. Most state that they are committed to uphold the values and support staff who follow the guidance.

It also is seen as a way of making known the general rules that underpin a company's operations.

BAE does not appear to have an orthodox Code. It does have a UK Ethics Statement. This is a one page statement signed by the CEO in February 2006. Beside the corporate values, it sets out nine clauses on what the company does and does not do on five issues: compliance, political influence, anti-bribery, workplace environment and security of information. The purpose of its ethics policy is set out in a separate document: 'Ethics and you' and also as part of its US code. This latter code is much more in line with the codes of the companies under review.

3. Implementation of Values and Ethics Policy

A. Expected Behaviour of Employees and Disciplinary Action

Four companies, all of which are based in the US,

require a written acknowledgment of awareness of the contents of the code and the requirement for adherence to it. One, Lockheed Martin, extends this requirement to agents, consultants or contract workers.

A review of the codes indicates that there are four elements of a policy which taken together form a standard for good practice:

- a) Set out clearly the standard of behaviour expected of employees at all levels and others associated with the organisation.
- b) Provide a means for employees to raise questions.
- c) Give a warning to expect disciplinary action if there are breaches of the requirements.
- d) Require others closely involved with the company to adhere to your code

B. Expected Behaviour of Managers

It is rare to see specific behavioural expectations for managers in a code. However, a majority of companies in the survey consider it necessary to emphasise particular responsibilities of their managers around both preventing breaches of the code and promoting ethical standards. The North American business of BAE poses two questions for their managers 'Do I encourage an open environment?' and 'Do I model the behaviors the company policy encourages?'

The wording in the GSK code on management behaviour is exemplary!

C. Speak Up Arrangements

Most large companies (and other organisations) provide a means for employees (and other) to raise issues either as a report or by asking for advice from others than their line managers. Experience with Helplines (or Hotlines, SpeakUp lines etc.) is mixed but most say they are a valuable means of detecting problems before they become unmanageable.

The Corporate Governance Rules of the NYSE require listed companies to have a code of ethics (Section 303A.10). The ruling states, among other things, that a company should encourage employees to report illegal or unethical behaviour.

A provision of confidentiality is given in nearly all cases and it is seen by all but one to be important to assure (genuine) whistleblowers that retaliation for their speaking up will not be tolerated.

BAE's policy and practice on speak up is presented in a way that is easy to understand and assures staff

about confidentiality and non retaliation.

[More examples and information are available in: IBE Good Practice Guide: Speak Up Procedures (IBE, 2006) and from Public Concern at Work (www.pcaw.co.uk).]

D. Tools for Ethical Decision-Making

The provision of guidance to staff on identifying potential or actual unethical actions is one of the most helpful (and user friendly) aspects of codes. As this small sample shows, guidance is not found in all codes including that of BAE. It is good practice to provide such guidance, usually in the form of key questions to ask about decisions. Lockheed Martin's Warning Signs of being on ethical thin ice are unusual and appropriate.

E. Ethics Offices and Governance; Ethics Training Programmes

There is some anxiety among business ethics practitioners that while values, policies and codes are well developed, their implementation and embedding into business practice is not always effective. This includes governance; training, monitoring and accountability (see also Section F below).

From the examples in this survey, the codes themselves rarely are specific about implementation and embedding. Practice differs widely. BAE indicates the existence of Committees, Departments and Ethics Officers. The North American business provides training resources and requires all staff to undertake initial and refresher training.

The provision of training on business ethics is mentioned by the majority of the sample: The elements range from issuing a code to all staff (Thales) to detailed training on a variety of ethics and compliance issues (Lockheed Martin).

These issues are addressed in two IBE publications *Making Business Ethics Work: The foundations of effective embedding* (2006) and *Living Up To Our Values: Developing ethical assurance* (2006).

F. Monitoring and Auditing of Ethics Policy and Programme

It is evident that in the published values and ethics policies and programmes of the selected companies, little is mentioned about monitoring and auditing their effectiveness.

Where there is a reference, it is usually concerning material risks and couched in legal and compliance terms.

BAE does not refer to any monitoring or auditing of its programme in public documents.

Nevertheless, it is known that the companies under review do have systems for monitoring and auditing policies in place. This becomes more obvious when the sections on values and ethics in Annual Reports and Corporate Responsibility Reports are analysed (see Table 2: Reporting to stakeholders [including shareholders] on values and ethics policies).

G. Review of Policy or Code

Little is mentioned in policies in the public domain about regular reviews of ethics policy. Only Anglo American and BAT of the companies reviewed have a policy on this.

Good practice is to review/revise them at least every three years.

4. Relations with Government

A. Government Contracts; Bribery and Corruption of Officials

The Boeing statement in relation to government contracts is the most comprehensive – probably due to difficult experiences that it went through involving unethical behaviour in this area a decade ago.

The most 'user friendly' statement on government contracts is the one provided by GSK.

On the issues of bribery and corruption of government officials, there is a marked difference between US-based companies and others. This involves the tolerance of facilitation payments (small amounts of money given to a public employee to perform their normal duty or to hasten it). For UK companies, these payments are illegal anywhere in the world but are allowed (but discouraged) in other jurisdictions.

Detailed guidance is provided by Lockheed Martin on the cash values allowed in gifts and entertainment.

BAE makes a straightforward statement outlawing bribes and improper inducements. The North American business singles out the giving and receiving of gifts and also has a robust statement about competing fairly and refers to the Procurement Integrity Regulations.

B. Political Contributions/Lobbying; Hiring of Public Officials

The position of US companies on political contributions differs from those in other countries because of PAC (Political Action Committee) provision, which allows the collection from employees and their distribution to political parties.

Most companies do not allow donations or other contributions to political parties by the corporation in its own right.

North American companies, including BAE North America, have clear statements regarding hiring present or former government officials. No other companies in the sample mention this in publicly available documents.

The US companies (Boeing, Coca-Cola, Lockheed Martin and BAE Systems [NA]) all refer to the US laws and the conflicts of interest tests when recruiting or hiring current or former government officials.

C. Export Controls, Boycotts and Other Related Policies

Codes of ethics may not be the best place to set out the details of this subject which is largely based on legal or regulatory requirements. However, staff need advice if there is any form of discretion involved.

All of the companies except Lockheed Martin and BAE (UK) have clear guidance on export controls and other government trade policies. BAE (NA) refers to this and their UK operation refers to the protection of Government information and national security requirements.

Some codes refer to control of government classified information.

GSK's approach commends itself as a way of effectively communicating policy in this area.

5. Relations with Agents and Consultants

Most of the codes in this sample make it clear that the policy and guidance contained in them apply equally to those who represent them in any capacity including agents and consultants. BAT, GSK, Thales, BAE and ABB do not mention this.

Bribery by third parties (acting for a company) in any of its forms is specifically prohibited in most codes (including that of BAE). GSK is the only code that requires its agents to abide by competition law. It's

list of 12 issues that are covered by guidance are comprehensive.

COMMENTARY ON CORPORATE REPORTING TO STAKEHOLDERS (INCL. SHAREHOLDERS) ON VALUES AND ETHICS POLICIES

(Table 2) (not included here, see www.woolfcommittee.com)

The additional information from Annual Reports and Corporate Responsibility Reports (or their equivalents) shows that the majority of companies feel it important to communicate to outsiders about the effectiveness of their values and ethics programmes.

Five areas of interest were selected for analysis:

- Comments on values and codes of ethics
- Speak up lines and code breaches
- Training on ethics
- Bribery and Corruption
- Key Performance Indicators (KPIs)

BAE Systems report on *all* these areas as do five others.

US companies generally do not provide as much information as others.

In Boeing's and Northrop Grumman's case, they only mention their code in their Annual Report in the form of an aspirational statement.

Lockheed's Reports simply states that the code, helpline and training are in place.

The most explicit reports with data are those of ABB, Anglo-American, BAT, GSK, Shell, Thales and BAE Systems.

On the matter measurement against KPIs, BAE ranks among the most explicit. It sets out in its CR Report the objectives and achievements for 2006 and 2007. In their Annual Report, there are details of the indicators used by the Board to measure how it is fulfilling its responsibilities in the five areas that were analysed.

Others with KPIs include BAT, who measure against the Global Reporting Initiative (GRI) G3 list, and ABB use the UN Global Compact reporting standard.



PART II

Summary of results of a questionnaire on corporate values and ethics policies

Introduction

Part II of the research undertaken by the IBE on behalf of the Woolf Committee, was based on responses to five questions sent to five large multinational companies.

The questions asked were:

1. What guidance, if any, is provided for conducting commercial discussions leading to contracts, with representatives of national governments?
2. What guidance is provided on the recruitment, remuneration, supervision and accountability of agents/advisors?
3. What, if any, ethical criteria have to be met by a company before proceeding with a contract, acquisition or joint-venture? At what level and at what stage are such decisions taken in cases where ethical (reputational value) concerns may be a factor?
4. By what means are your values and ethics 'embedded' in your corporate culture?
5. How do you know your values and ethics policies are working? What metrics do you gather on this?

It was agreed that the specific replies should remain confidential.

Commentary on the information contained in the replies

Question 1

What guidance, if any, is provided for conducting commercial discussions leading to contracts, with representatives of national governments?

All respondents set out (often in detail), their approach to staff guidance on contracts with representatives of national governments. It is however markedly different depending on the economic sector and location of the business.

Two distinct approaches emerge:

- That based mainly on compliance with laws and regulations
- That based on core principles.

For instance, one company states:

"Concerning national governments contracts, (we) entrust the commercial discussions to a specific team including Sales and Contract Managers, committed to conduct business to the highest moral and ethical standards in strict compliance with the rules of fair trading, codes of practice, laws and regulations including anti-bribery laws governing public procurement."

Most respondents refer to their code of ethics/conduct etc. when introducing their policies on this topic.

All remind their staff of the relevant legislation in different countries which regulate the relationships with 'government' customers as well as those in the private sector.

Among these are:

- Foreign & Corrupt Practices Act (FCPA) (1978)
- Anti Kick-Backs Act (1986)
- Federal False Claims Act (1986)
- Procurement Integrity Act (1988)
- Truth in Negotiations Act (2006)

And from the UK

- Anti Terrorism, Crime & Security Act (2001)

Question 2

What guidance is provided on the recruitment, remuneration, supervision and accountability of agents/advisors?

Most respondents have explicit policies regarding their relationships with agents, advisors, consultants, contractors etc.

The following issues were referred to in the responses to this question:

- Roles of agents/consultants, advisors
- Ethics standard required of agents
- Recruitment procedures
- Vetting of remuneration and expenses of agents
- "Disguised" commissions
- Competitive Intelligence
- Facilitation Payments

Some have a company manual on policies and procedures for business external providers (or similar title) which is designed to make its processes stricter and more exhaustive throughout their business.

All but one of the respondents state that they expect their agents (however they are described), to conform to their company's code/standards of conduct.

However, only a minority set out the process for monitoring this aspect of their policies. It can perhaps be inferred that only limited attention is paid to this.

Question 3

What, if any, ethical criteria have to be met by a company before proceeding with a contract, acquisition or joint-venture? At what level and at what stage are such decisions taken in cases where ethical (reputational value) concerns may be a factor?

All the respondents answered this question. But only a minority seem to have a policy and process for reducing the potential reputation risk caused by the activities of those with whom they do business. Most have legal and financial due diligence procedures for joint ventures, but none indicated that had one for assessing reputation risks.

Other related issues referred to in replies include:

- The alignment of the acquisition target's corporate values with that of the company
- Mergers and acquisition committees to vet and authorise acceptance.

Question 4

By what means are your values and ethics 'embedded' in your corporate culture?

The respondents have in place most of the generally accepted tools for embedding their values and implementing ethics policies.

Most replies set out their company's overall ethics programme. This includes:

- The promulgation of the code of ethics
- Training programmes
- The role and function of the ethics office
- Help lines and means of reporting violations
- Board and senior management committees to monitor the programme
- Ethics 'ambassadors' located at different geographical locations where the company has a presence.

To what extent these 'tools' are effective in reducing unethical behaviour at any level of an organisation is difficult, but not impossible, to measure.

A growing number of large companies have committees at a senior level (including the board), for evaluating the effectiveness of their values and ethics policies. There are processes available to help provide

them with a degree of ethical assurance.

Question 5

How do you know your values and ethics policies are working? What metrics do you gather on this?

The data on the effectiveness of policy that is collected by the respondent companies includes those derived from:

- Contacts made by staff and others with the ethics/compliance function
- Contacts made via help lines or other reporting facilities. (These are often categorised according to issue and seriousness.)
- Records of infractions of policy and disciplinary procedures
- Regular surveys of staff
- Internal audit investigations
- Proportion of staff undertaking training in a year
- Benchmarking against external standards

Actions arising from ethical or compliance lapses were listed by some companies with comparative numbers in past years.

Some overall conclusions

- The respondents all provided (often detailed) guidance for their staff on commercial interaction with governments.

Their policies were either couched in legal terms (compliance based) or more general, setting out and providing guidance on corporate standards concerning relations with all customers (principles based).

- The majority of respondents give clear guidance about all aspects of their relationships with agents, advisors, consultants etc.

Not all set out in their replies the process for monitoring of their policies in this regard. Nor is it clear how long contracts last.

- Regarding criteria to be met for proceeding with contracts acquisitions or joint ventures, only a few seem to have a clear policy and process around reputation risk. Most have normal due diligence procedures but they do not seem to cover integrity issues.
- Most respondents have the key tools for implementing their values and ethics policies in place.

- Some have well developed systems of committees at a senior level (including the board) for evaluating values and ethics policies.
- The collection of monitoring data about staff knowledge of, and adherence to, standards varies from company to company.



PART III

Selected international business ethics standards with particular reference to anti-bribery and corruption standards

Organisation	Standard	Content	Requirements
UN Global Compact	Ten Principles http://www.unglobalcompact.org/	<p>The Principles are rooted in international conventions and address</p> <ul style="list-style-type: none"> • Human rights • Labour standards • Environment • Corruption 	<p>The UN Global Compact is a voluntary corporate citizenship initiative.</p> <p>“Joining the Global Compact is a widely visible commitment to the ten principles. A company that signs-on to the Global Compact specifically commits itself to:</p> <ol style="list-style-type: none"> 1) set in motion changes to business operations so that the Global Compact and its principles become part of management, strategy, culture, and day-to-day operations 2) publish in its annual report or similar public corporate report (e.g. sustainability report) a description of the ways in which it is supporting the Global Compact and its principles, and 3) publicly advocate the Global Compact and its principles via communications vehicles such as press releases, speeches, etc.”

Organisation	Standard	Content	Requirements
OECD	Guidelines for Multinational Enterprises http://www.oecd.org/document/28/0,3343,en_2649_34889_2397532_1_1_1_1,00.html/	<p>These guidelines are recommendations for responsible business conduct proposed by governments to multinational enterprises operating in or from the countries that adhere to the guidelines. The guidelines cover a broad range of issues including:</p> <ul style="list-style-type: none"> • employment and industrial relations • human rights • bribery • consumer interests • environment • information disclosure • competition • taxation • science and technology. 	<p>“The governments of the countries adhering to the Guidelines – which are the source of most of the world's direct investment flows and home to most multinational enterprises – agree to promote their implementation by enterprises operating in or from their territory.</p> <p>The institutional set-up for promoting implementation of the Guidelines is described in an OECD Decision and its Procedural Guidance. It consists of three main elements:</p> <ul style="list-style-type: none"> • the National Contact Points • the OECD Investment Committee • the advisory committees of business and labour federations, BIAC and TUAC, respectively, and NGOs represented by OECD Watch.”

Organisation	Standard	Content	Requirements
World Economic Forum	<p>Partnering Against Corruption Initiative (PACI) Principles</p> <p>http://www.weforum.org/en/initiatives/paci/index.htm</p>	<p>This standard addresses bribery only.</p> <p>The standard encompasses:</p> <ul style="list-style-type: none"> • Bribes • Political Contributions • Charitable Contributions and Sponsorships • Facilitation Payments • Gifts, Hospitality and Expenses <p>The standard also sets out various programme implementation requirements.</p>	<p>“The PACI is based on CEO commitment to zero-tolerance towards bribery and commitment to implement a practical and effective anti-corruption program within the company - or for companies that already have a program in place to benchmark the existing program against the PACI Principles.”</p> <p>Companies can become signatories to the initiative.</p> <p>Three stage commitment to implementation:</p> <p>STAGE 1 (mandatory): Developing and implementing an internal programme (or if programme already exists benchmarking against PACI Principles)</p> <p>STAGE 2 (invited): Self-monitoring and self-evaluation</p> <p>STAGE 3 (optional): External verification / Third-party certification</p> <p>Signatory companies are encouraged to submit a report within 2 years of signature.</p>

Organisation	Standard	Content	Requirements
Transparency International	<p>Business Principles for Countering Bribery</p> <p>http://www.transparency.org/global_priorities/private_sector/business_principles</p>	<p>This standard addresses bribery only.</p> <p>The standard encompasses:</p> <ul style="list-style-type: none"> • Bribes • Political Contributions • Charitable Contributions and Sponsorships • Facilitation Payments • Gifts, Hospitality and Expenses <p>The standard also sets out various programme implementation requirements.</p>	<p>“The Business Principles provide a model for companies seeking to adopt a comprehensive anti-bribery programme. [TI] encourage[s] companies to consider using the Business Principles as a starting point for developing their own anti-bribery programmes or as a benchmark for existing ones.</p> <p>To support the users of the Business Principles, TI has produced a suite of tools, including a comprehensive Guidance Document which provides additional background and practical information for those wishing to implement the Business Principles or review their own anti-bribery processes. The TI Six Step Implementation Process is a how-to guide for companies that are early on in the process of devising and implementing an anti-bribery programme. TI is also developing a Self-Evaluation Module to assist companies wishing to assess their anti-bribery performance.”</p>

Organisation	Standard	Content	Requirements
International Chamber of Commerce	Combating Extortion and Bribery: ICC Rules of Conduct and Recommendations http://www.iccwbo.org/policy/anticorruption/id870/index.html	<p>This standard addresses bribery and extortion only.</p> <p>Contents:</p> <ul style="list-style-type: none"> • Prohibition of Bribery and Extortion • Agents and Other Intermediaries • Joint Ventures and Outsourcing Agreements • Political and Charitable Contributions and Sponsorships • Gifts, Hospitality and Expenses • Facilitation Payments • Corporate Policies • Financial Recording and Auditing • Responsibilities 	<p>“The ICC Rules outline the basic measures companies should take to prevent corruption. These Rules of Conduct are intended as a method of self-regulation by international business. Although they are without direct legal effect, the Rules of Conduct constitute what is considered good commercial practice in the matters to which they relate.”</p>

Organisation	Standard	Content	Requirements
<p>Defense Industry Initiative on Business Ethics and Conduct (US)</p> <p>(consortium of U.S. defense industry contractors)</p>	<p>http://www.dii.org/</p>	<p>“DII’s essential purpose is to combine the common dedication of its Signatories to a culture and practice of ethics and right conduct in all business with the U.S. Defense Department and with others. The defense industry Signatories are united in the commitment to adopt and implement principles of business ethics and conduct that acknowledge and address their organizational responsibilities under federal procurement policy and law, thereby contributing to the National Defense. Further, they each accept the responsibility to create an organizational culture in which ethics is paramount, and compliance with federal procurement laws is a strict obligation.”</p>	<p>Companies can become signatories.</p> <p>“As a signatory, a DII company commits to adopt and adhere to the DII’s six principles of business ethics and conduct:</p> <ol style="list-style-type: none"> 1. Each company will have and adhere to a written code of business ethics and conduct. 2. The company’s code establishes the high values expected of its employees and the standard by which they must judge their own conduct and that of their organization; each company will train its employees concerning their personal responsibilities under the code. 3. Each company will create a free and open atmosphere that allows and encourages employees to report violations of its code to the company without fear of retribution for such reporting. 4. Each company has the obligation to self-govern by monitoring compliance with federal procurement laws and adopting procedures for voluntary disclosure of violations of federal procurement laws and corrective actions taken. 5. Each company has a responsibility to each of the other companies in the industry to live by standards of conduct that preserve the integrity of the defense industry. 6. Each company must have public accountability for its commitment to these principles. <p>To ensure consistent compliance with these principles, each signatory company is required to respond to a detailed annual questionnaire, and to participate in the annual DII “Best Practices Forum”.</p>

Organisation	Standard	Content	Requirements
<p>Aerospace and Defence Industries Association of Europe (ASD)</p>	<p>Common Industry Standards for European Aerospace and Defence</p>	<p>The Standards require all associations to comply with the laws and regulations of the countries or territories from which they work. This includes:</p> <ul style="list-style-type: none"> • the prohibition of corrupt practices, such as the offering, promising or receiving of bribes – be it to public or private individuals/co-operation; • gifts and offers of hospitality, which must not be done with a view to obtaining improper advantage. They must also be accountable and traceable in the books and records of the giver; • political donations and contributions – these must be treated in a similar way as gifts and offers of hospitality; • the responsible management of agents, consultants and intermediaries, which will require companies to perform a thorough due diligence examination for all candidates, and will require renewal on a regular basis. <p>(SBAC Press Release)</p>	<p>“The Standards require all associations to comply with the laws and regulations of the countries or territories from which they work.”</p> <p>(SBAC Press Release)</p>

Organisation	Standard	Content	Requirements
International Council of Chemical Associations	Responsible Care (Global Charter) www.responsiblecare.org	Responsible Care® is the chemical industry's global voluntary initiative under which companies, through their national associations, work together to continuously improve their health, safety and environmental performance, and to communicate with stakeholders about their products and processes	<p>“Responsible Care is a commitment, signed by a chemical company's Chief Executive Officer (or equivalent in that country) and carried out by all employees, to continuous improvement in health, safety and environmental performance, and to openness and transparency with stakeholders. It helps companies improve performance by identifying and spreading good management practices, and promotes mutual support between companies and associations through experience sharing and peer pressure.”</p> <p>Implemented through National Trade Associations</p> <ol style="list-style-type: none"> 1. Adopt Global Responsible Care Core Principles <ul style="list-style-type: none"> - continuously improve environmental, health and safety knowledge and performance of technologies, processes and products - efficient use of resources, minimise waste etc. 2. Implement fundamental features of national responsible care programmes. 3. Commit to advancing sustainable development 4. Continuously improve and report performance 5. Enhance management of chemical products worldwide – Product Stewardship 6. Champion and facilitate the extension of Responsible Care along the chemical industry's value chain 7. Actively support national and global responsible care governance processes 8. address stakeholder expectations about chemical industry activities and products 9. Provide appropriate resources to effectively implement Responsible Care

Other standards: AccountAbility's AA1000 Framework (process standard), SA 8000 (labour standard) etc, GRI Guidelines (reporting guidelines).

Appendix G

Pitfalls of the defence industry

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December 2007

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Executive Summary

This report analyses the strategic and political context in which defence contractors operate when engaging in arms transfers, and the ‘moral hazards’ exports can create for industry and national governments. In doing so, it addresses five main themes.

Section 1 evaluates the nature of defence-industrial activity and the relationship that exists between governments and their major domestic suppliers in major weapons exporting states. It clarifies the significant conceptual and empirical difficulties in defining, delineating and measuring defence-related production and establishes the core drivers for national governments to act as the major customer, sponsor and regulator of their major domestic military equipment suppliers.

Section 2 analyses how the close relationship between defence industries and governments extends beyond domestic defence markets to the sphere of arms transfers. It surveys generic supplier and recipient motives for arms transfers, the factors determining the degree of government involvement in the technology transfer process and the regulatory environment affecting defence exporting firms. The section exposes the range of economic and politico-military benefits that supplier and recipient governments and industries anticipate from arms exports, and the range of technology transfer arrangements that are employed.

Section 3 surveys global trends in international arms sales and the nature of the current defence market environment. This section outlines the major developments in global military expenditure, regional defence expenditure trends, and the ways in which the industrial content and context of arms production ownership has evolved. This provides the basis for a detailed survey of arms import and export patterns and the nature of trade flows in the current global defence markets.

Section 4 analyses the constraints affecting governments in defining, identifying and regulating the transfer of ‘dual-use’ technologies. It shows that there are an array of national and international actors involved in regulating dual-use technologies, the lack of a single unified list of restricted export technologies and limitations in monitoring and enforcement regimes. These factors create a ‘grey area’ for government and industries that falls between normal civil and dedicated military exports.

Section 5 draws on the preceding analysis to assess the ‘moral hazards’ confronting industry and governments in arms transfers, and how these hazards can be assigned between business and the state. It evaluates the moral hazards against the backdrop of influential ethical and practical concerns about the arms trade, and concludes that:

- The overall framework for arms transfer policy and key strategic judgements are for national governments;
- Exporting firms acting within this framework may assess that they have no special ethical case to answer;
- However, a range of ethical dilemmas can arise for companies in terms of their interpretation of government frameworks and in a range of specific circumstances where they have choices in how to behave.

Section 1: Defence Markets and the Nature of Government-Industry Relationships

The primary focus of this study is to analyse the strategic and political context in which defence contractors operate when engaging in arms transfers, and the 'moral hazards' exports can create for industry and national governments. As it can be misleading to consider exports in isolation, consideration must initially be given to the nature of the defence industrial base and the relationships that exist between governments and their major domestic suppliers in the major weapons exporting states.

1.1: Defining the Defence Industrial Base (DIB)

Defence markets have a unique set of characteristics that lead to particular forms of relationships between national governments and their key defence equipment suppliers. The special nature of government-industry relationships in weapons exporting states are a major determinant of their arms transfer policies and practices. National governments are required to act as the main customer, sponsor and regulator of their major military equipment suppliers.

The term 'defence industrial base' (DIB) is frequently employed in analyses of defence-industrial sector, but has no universally accepted definition. This stems from significant conceptual and empirical difficulties in defining, delineating and measuring defence-related production. At the conceptual level, in most developed industrialised states the DIB is held up as 'a central part of national defence policy' but the concept 'has been the victim of various definitions, meaning different things to different people'.¹ This reflects several factors that complicate a robust distinction between those sectors of industrial activity relating to military and non-military expenditure. As Molas-Gallart points out, several approaches can be employed to distinguish defence and non-defence activity, each with their own analytical benefits as well as limitations:²

- The DIB can be defined as the provider of all the products, goods and services bought by a national defence agency and the armed services. Though this definition captures all the purchases made by the national defence agency as a *client*, it lacks discrimination because it fails to distinguish items

that are specific to the armed services from those used in the civilian economy.

- A further distinction can be drawn between *non-specialised* and *specialised products* purchased by national defence agencies. The DIB is defined as that part of the economy providing specialised defence used only by the military, involving distinct and separate production systems, and excluding non-specialised goods requiring little transformation purchased directly from the civilian economy. Though this provides a more meaningful distinction between defence and non-defence purchases, it fails to capture the degrees to which products fall into the non-specialised and specialised categories – an issue that is developed further in Section 4 in relation to 'dual-use' items.
- A third approach discriminates final uses for products purchased by national defence agencies from the DIB in terms of whether or not they are *designed unequivocally for military use* (e.g. nuclear submarine) or not (e.g. transport aircraft). An issue with this criterion is how to treat a range of items that are critical enablers for the delivery of military capability, such as communications, satellite, and surveillance equipment.
- A further approach defines the DIB in terms of the reliance of suppliers on national defence agency contracts. 'Defence contractors' are defined as those firms that are highly dependent on defence sales. A limitation of this criterion in isolation is identifying the percentage of a company's defence activity that constitutes the threshold for categorisation as a 'defence firm'.

These conceptual difficulties in delineating the DIB are compounded by empirical constraints in measuring and quantifying defence research and development (R&D) and production. As Sandler and Hartley point out, 'data problems abound. For researchers, difficulties arise in obtaining accurate and reliable data on the size of the world's defence industries... These difficulties reflect secrecy and the problems of defining the extent and composition of the DIB... Some suppliers might not be aware that they are involved in defence production. For example, ball bearing manufacturers are unlikely to know whether their products are used in motor cars or main battle tanks'.³

¹ T, Sandler & K. Hartley, *The Economics of Defense*, (Cambridge: Cambridge UP), 1995, p. 182.

² J. Molas-Gallart, *Military Production and Innovation in Spain*, (Reading: Harwood Academic Publishers), 1992, pp. 26-29. See, also, T, Sandler & K. Hartley, *The Economics of Defense*, (Cambridge: Cambridge UP), 1995, p. 182.

³ T, Sandler & K. Hartley, *The Economics of Defense*, (Cambridge: Cambridge UP), 1995, p. 183.

Acknowledging these constraints, this study focuses primarily on defence-related production and international transfer of the most complex defence-specific systems, particularly complete platforms (e.g. combat aircraft, warships and submarines). These systems require the integration of items available in commercial markets and defence-specific sub-systems. The key characteristics of these products are high unit cost, substantial technical risk and limited sources of supply. These product types are not available in commercial markets but include production from firms with varying degrees of dependence on defence contracts in terms of their overall corporate sales. This emphasis reflects the particular focus of the Woolf Committee, and still allows for general conclusions to be drawn in relation to defence-related purchase and export of low-cost commercially available items and intermediate-scale sub-systems and stand-alone weapons.

1.2 Government Relationships with Domestic Defence Equipment Suppliers

Throughout the Cold War, the threat posed by the Soviet Union meant that the strategic imperative in the UK and other North Atlantic Treaty Organisation (NATO) states was for equipment performance enhancements to keep up with perceived Soviet capabilities. Weapons systems went through successive generations. In this environment, military contingency planning for the worst case created 'ever-increasing demand to modernise equipment, with cost only a minor concern'.⁴ This imperative for military systems performance increases had two major implications that cast a shadow forward over contemporary weapons acquisition for complex defence platforms and defence markets.

First, since 1945, the trend has been for the unit production cost of complex weapons systems to increase rapidly in real terms.⁵ The real costs of tactical combat aircraft have been growing at 10 per cent per annum, with similar rates of growth for guided missiles, submarines, frigates, attack helicopters and self-propelled artillery.⁶ Though defence budgets in the UK and elsewhere have

grown at the same time as equipment costs have been rising, budgetary increases have been smaller, and 'only partially compensated for the concurrent escalation in the unit cost of defence equipment'.⁷ A related trend has been significant increases in programme 'lead-times', or the time between project initiation and operational release to the armed services, as successive generations of major defence platforms have been replaced.⁸ Moreover, the stress on successive inter-generational performance enhancements has meant that major weapons system programmes have been characterised by increasing research and development (R&D) intensity. The implications of these trends are summarised in Kirpatrick's 'positive feedback' framework: the stress on weapons performance has increased inter-generational equipment unit costs, which has increased unit costs and resulted in fewer units of equipment ordered. In turn this has led to less frequent renewal and a demand for significant performance enhancements and increased R&D intensity for each new generation.⁹

The second feature that pre-dated the Cold War in the UK and elsewhere was a desire for independence, which led to the creation of largely separate national arms industries capable of developing and producing a range of advanced weapons systems indigenously. At the most general level, self-sufficiency has been equated with 'strategic autarky', or national self-determination in defence and foreign policy, as if this could be provided by control over replacement parts. National autonomy in weapons development has also been viewed as a source of national independence, a means of achieving security of equipment supply and a way of tailoring equipment requirements to the precise needs of the armed services. Lastly, self-sufficiency has been equated with national economic benefits in the form of domestic employment in high-technology sectors, support for balance of payments and tax revenues, as well as a source of technological 'spin-offs' that civilian industry could exploit.¹⁰ Evidence of 'buy national' policies was that by the late 1980s domestic sourcing accounted for between 70 per cent and 95 per cent (by value) of the defence equipment budgets of West Germany, France and the

⁴ J.P. Dunne & E. Surry, 'Arms Production', *SIPRI Yearbook 2006: Armaments, Disarmament and International Security*, Oxford: Oxford University Press, 2006, p 396.

⁵ See, for example, D.L.I. Kirpatrick & P.G. Pugh, *Towards Starship Enterprise – Are Current Trends in Defence Unit Costs Inexorable?* (London: Aerospace), 1983.

⁶ D. Kirpatrick, 'Rising Costs, Falling Budgets and their Implications for Defence Policy', *Economic Affairs*, Vol. 17, No. 4, 1997, p. 11.

⁷ *Ibid.*, p. 10.

⁸ See, for example, D.L.I. Kirpatrick & P.G. Pugh, *Towards Starship Enterprise – Are Current Trends in Defence Unit Costs Inexorable?* (London: Aerospace), 1983.

⁹ See D. Kirpatrick, 'Rising Costs, Falling Budgets and their Implications for Defence Policy', *Economic Affairs*, Vol. 17, No. 4, 1997, p. 11.

¹⁰ See, for example, M.R.H. Uttley, 'Defence Procurement and Industrial Policies', in S. Croft, A. Dorman, W. Rees & M Uttley, *Britain and Defence 1945-2000: A Policy Re-evaluation*, (London: Longman), 2001, p. 117.

United Kingdom. Relatively high levels of Cold War defence equipment expenditure and a desire to source nationally where possible for domestic political reasons, often outweighed the potential economic gains from greater market liberalisation or the placing of major orders with non-national suppliers.

The consequences of the twin imperatives of weapons system performance enhancements and protectionist defence-industrial policies for government-industry relationships persist to this day. They created conditions where, unlike many other industrial sectors, the financial risk of weapons development 'was borne by government, which often financed R&D and in some cases provided investment capital and infrastructure',¹¹ and government defence contracting controlled domestic market structures, entry and exit, and regulated company profits. The nature of this relationship reflected three main factors.

1. Monopsony: defence markets are characterised by one buyer, the national defence ministry. Though a percentage of production has been exported, for most firms this has been a small proportion of output, and defence industries have been reliant on the decisions of a sole customer.
2. Cost inflation trends in major weapons platforms during the Cold War meant domestic defence industries became relatively concentrated in particular weapons platform sectors (shipbuilding, aircraft) and systems (avionics, fire control systems). Government perceptions that major prime contractors were a 'national resource' meant that defence officials would not allow large production lines 'to wither and die for lack of a large production contract'.
3. Prime contractors were unwilling to shoulder key uncertainties associated with the development and production of advanced weapons systems with private capital. Industry concerns at the initiation of new weapons projects surrounding future military production demand, technological risks associated with R&D activity and uncertainties about continued programme budget allocations, forced government to underwrite R&D costs and sustain production lines.

Despite a series of post-Cold War defence market adjustments, the 'arms industry's size, structure and trade are still determined by government policy, as the national government is still the main customer and regulates exports'.¹² Since 1990, several major developments have occurred in defence markets.

National defence expenditures in the USA, Europe and the former Soviet Union declined significantly in the early 1990s as states sought 'peace dividends'. This led to a fall in unit demand for weapons platforms. Reduced equipment orders were instrumental in defence-industrial restructuring.

Extensive market concentration occurred within US and European national borders.

A gradual breakdown of national ownership patterns through government-mandated international company mergers and take-overs. Examples here include the creation of BAE Systems, Thales and EADS in Europe.¹³

Significant growth in tendering for defence contracts by trans-national consortiums. This was encouraged by government as it has increasingly sought to hand over responsibility for product development, production, training and support to industry for the product's life rather than retain it within the armed forces. For example, see the philosophy and approach behind acquisition of the Future Strategic Tanker Aircraft¹⁴ or the new aircraft carriers.¹⁵ The Ministry of Defence's approach to existing systems has also changed typified by the signing of two contracts with BAE Systems and Rolls-Royce to provide overall responsibility for Tornado support rather than maintain over 300 contracts itself.¹⁶

On the one hand, an outcome has been a reduction in the traditional influence and control that governments have enjoyed over domestic defence industries. On the other, as Dunne and Surry point out, the current situation is that:

Governments dominate the demand for the products of the sector, and their spending and direct influence inevitably determines industrial structure: governments still decide where to buy, how to buy and what to buy... They can still influence the size

¹¹ J.P. Dunne & E. Surry, *Ibid.*, p 396.

¹² J.P. Dunne & E. Surry, *Ibid.*, p 396.

¹³ 'Aerospace and Defense Industry Restructuring, January 1985-December 2005', *Defense News*, 22 May 2006, pp.18-23.

¹⁴ 'UK studies revised tanker bid', *Jane's Defence Weekly*, vol.41, no.28, 14 July 2004, p.21.

¹⁵ Denise Hammick, 'UK CVFs finally get green light', *Jane's Defence Weekly*, vol.44, no.31, 1 August 2007, p.5.

¹⁶ Andrew Chuter, 'UK Defence Ministry to study Tornado savings', *Defense News*, 10 January 2005, p.10; Michael J Gething, 'UK MoD awards Tornado support contracts', *Jane's International Defense Review*, February 2006, p.27.

and structure of the industry, entry to and exit from the industry, efficiency and ownership, and the level of technology and exports.¹⁷

Section 2: Arms Transfers and National Policy

The close relationship between defence industries and governments extends beyond domestic defence markets to the sphere of arms transfers. In one of the most conceptually and empirically enduring studies on the subject, Katrina observes that:

Arms transfers are something apart from “normal” trade in other commodities because of their political significance, which derives from several factors. A first point is that arms – and arms transfers – are closely related to security, one of the most basic goals of the state. A second reason to look at arms transfers not primarily as a commercial but a political subject is linked to the fact that arms transfers are often perceived as gestures for political support transcending the pure military utility. The political significance of arms transfers is further reinforced by their potential or actual impact on the global distribution of military capabilities. That even governments usually quite permissive in divulging information on military affairs are not willing to disclose very much about arms transfers tends to reinforce the impression that this is a politically sensitive issue.¹⁸

The closeness of government-industry relations in arms supplying states reflects both the government’s role as the sponsor and regulator of its major suppliers and the range of perceived benefits that exports can provide for both parties. This section surveys generic supplier and recipient motives for arms transfers, the factors determining the degree of government involvement in the technology transfer process and the regulator environment affect defence exporting firms.

2.1 Supplier and Recipient Motives for Arms Transfers

Supplier and recipient governments and industries have claimed that arms transfers can provide economic and politico-military benefits. Though the comparative importance of these assumed gains may vary on a case-by-case and country-by-country basis, they provide a framework for analysing generic supplier and recipient motivations.

Arms supplying states have emphasised several national economic and industrial benefits in their arms transfer policies:

- It is assumed that arms transfers provide a mechanism to offset inflationary trends in domestic military R&D and production for major defence platforms. This can be achieved because export orders increase domestic manufacturing runs beyond what they otherwise would have been, thus enabling the fixed R&D cost of weapons development to be spread over a larger production output. Longer domestic manufacturing runs thereby enable economies of scale in production and ‘learning economies’, and ‘help to smooth production rates, keep production lines open and companies in business in times of low domestic demand’ which can assist in maintaining employment levels and high technology skills in supplier firms.¹⁹ A good example of this was the British Government’s decision to purchase a new generation of Hawk trainer aircraft which entailed the then Secretary of State for Defence, Geoff Hoon, giving ministerial direction to the Ministry of Defence over the issue.²⁰
- A related benefit is that arms transfers can help to ensure the economic viability of national contractors that, in turn, preserves domestic competition and maintains the scope of the defence industrial base.
- Further benefits cited or assumed by supplier governments and industries are the potential to exploit defence contracts as a market entry route for subsequent commercial sales, and positive contributions to national balance of payments. For

¹⁷ J.P. Dunne & E. Surry, *Ibid.*, p 413.

¹⁸ C. Katrina, *Arms Transfers and Dependence*, (New York: Taylor Francis), 1988, p. 12.

¹⁹ *Ibid.*, p. 71.

²⁰ David Henchke, ‘MoD chief refused to sign £800m Hawk order’, *Guardian Unlimited*, 10 December 2003, <http://politics.guardian.co.uk/homeaffairs/story/0,11026,1103611,00.html>

example, UK arms sales to Indonesia have been viewed as a mechanism to help other sectors of British industry, particularly in the oil and gas sectors.

In politico-military terms, supplier governments envisage that arms transfers can be a key tool in meeting national foreign and security policy goals. In the UK, for example, decision-makers have traditionally assumed that arms transfers can enhance influence and leverage over the domestic and foreign policies of importing states, and act as an important contributor to symbolic and security-specific objectives.²¹ There is a counter argument that suggests that governments fall into a 'subsidy trap' whereby they end up subsidising the weapon acquisitions of other states as a means of preserving their own DIB.²² Nevertheless, influence and leverage can take several forms:²³

- The transfer of weapons systems offers the supplier state with the potential to achieve general influence over the foreign and security policies of the recipient government or in relation to a specific aspect of security policy, particularly if the arms transfer leads to some form of recipient dependency.
- Arms transfers provide a potential mechanism for a supplier state to promote democracy or exercise leverage over recipient state policies, where the supplier employs the implicit or explicit threat to curtail arms transfers if the recipient government fails to comply.
- The symbolic importance attached to arms transfers provide the opportunity for supplier states to signal their general political commitment to a particular recipient state or government, irrespective of whether the nature or scale of the arms transfers provides influence, leverage or specific security gains.

Security-specific expectations from weapons supplying states have traditionally taken several forms:²⁴

- Transfers of conventional weapons have been viewed as a mechanism for non-proliferation because they can reduce perceptions of insecurity and reduce the incentives for possible nuclear, chemical and biological programmes in recipient states.
- It has been assumed that arms transfers increase levels of military capability and self-reliance in

friendly states. This capacity-building approach translates into a potential reduction of recipient dependence on external security guarantees and can provide the supplier state with a less costly alternative to direct military involvement in the event of conflict. A self-reliant ally is less likely to turn to you in a crisis. It also offers an indirect means to deter aggression against UK allies and a means to enhance regional stability. For example there was a readiness to strengthen Iraq during the 1980s to prevent its defeat in its war with Iran.

- Arms transfers offer potential military-to-military benefits in the form of supplier influence over tactical and doctrinal development in recipient armed forces, equipment interoperability and potential concessions that can include access to base facilities and over-flight rights. In essence, therefore, arms transfers are equated with maintaining linkages with strategically important allies as well as promoting the supplier states' wider interests.

The generic motives of arms transfer recipients reflect a different cost-benefit assessment of the economic, political and military implications. The perceived economic benefits have traditionally been two-fold. First, arms transfers provide the opportunity to exploit technology transfer, particularly where the transfer agreement allows for licensed production involving local manufacture of all or part of the weapons system in the recipient state. Second, the recipient's ability to negotiate offset agreements can offer increased access to export markets in the supplier state for civilian goods, with net economic gains.

At the politico-military level recipient states share many of the gains envisaged by suppliers. The symbolism and implied commitment of arms suppliers can manifest themselves as an expression of privileged status and perceived commitment in recipient countries. Arms transfers can also provide the recipient with leverage over the supplier state by, for example, threatening to switch supplier as a bargaining tool to extract political concessions.

Arms transfers provide recipients with enhanced military capabilities in the form of sophisticated weapons for the armed forces in the short term and potential opportunities to sustain technological advantage in the long term, particularly if the transfer has involved production and development rights.

²¹ See House of Commons Committee of Public Accounts, *Support for Defence Exports: Minutes of Evidence*, 26 April 1989, (London: HMSO, 1989).

²² See Paul Ingram & Ian Davis, *The Subsidy Trap: British Government Financial Support for Arms Exports and the Defence Industry*, (Oxford and London: Oxford Research Group & Saferworld, 2001).

²³ See C. Catrina, *Arms Transfers and Dependence*, (New York: Taylor Francis), 1988.

²⁴ For a more detailed discussion of these factors, see C. Catrina, *Arms Transfers and Dependence*, (New York: Taylor Francis), 1988.

2.2 Government, Industry and Arms Transfers

The preceding analysis demonstrates why arms transfers cannot simply be viewed as 'exports' with close parallels to international trade in civilian goods and services. The strategic importance of these sales ensures close attention by government. We therefore propose a typology for arms transfers based on the varying degrees of supplier and recipient government involvement.

At one extreme, the closest parallel to international trade in civilian goods are direct *commercial sales* of defence items by a firm in a supplier state with national government approval to a foreign recipient government. Commercial sales apply primarily for smaller weapons and components. A second category is offsets, which are 'a range of commercial compensation practices required as a condition of the purchase of defence articles and/or defence services'.²⁵ There are a range of offsets types differentiated according to whether the agreement is government-to-government or firm-to-government:²⁶

- *Licensed Production* involves overseas production of a defence item based upon the transfer of technical information under direct commercial arrangements between a firm and a foreign government or producer. For example, Agusta Westland have licence manufactured the Apache attack helicopter for the British Army. The acquisition of Eurofighter Typhoon by Saudi Arabia will include in-country production. Closely related to this are 'sub-contractor production', which mandates overseas production of a part or component of a defence article under direct commercial arrangement between a firm and a foreign producer; and, *overseas investment* arising from an offset agreement, taking the form of capital invested to establish or expand a subsidiary or joint venture in the foreign country. Other forms of defence technology transfer offsets include arrangements for *research and development conducted abroad* and *technical assistance*.
- *Co-production* agreements allow overseas production based upon government-to-

government agreement that permits a foreign manufacturer or government or producer to acquire the technical information and know-how to manufacture all the parts of an item of supplier equipment.

- *Collaborative projects* take the form of government-to-government formation of *joint ventures*, where firm-to-firm partnerships or conglomerates are formed to share risk and expertise; or of *strategic alliances* where defence contractors pool, exchange or integrate selected business resources for mutual benefit, while remaining separate entities.

The unifying feature of these arrangements is the requirement for government mandate and authorisation in the supplier state before the arms transfer can take place. In the UK case, the government controls arms transfers through export licences, and all transfers require a government licence before weapons can be shipped.²⁷ For multinational companies with sites in a number of countries this can pose significant internal problems as different parts of the organisation are subject to different government controls.

A second feature is the role of forms of supplier government 'security assistance' and subsidies for the transaction to take place. In the UK, for example, the 1980s and 1990s witnessed aggressive government-led export promotion strategies. The Defence Export Services Organization (DESO) was tasked to provide extensive support to industry in the marketing of defence products, and linking potential weapons buyers with UK defence manufacturers.²⁸ Governments also subsidized arms transfers in the form of 'export credits' that were designed to shift the financial risk from exporting companies to the British government through the extension of credit lines to overseas customers. During the mid-1990s, 'nearly 50% of export credit provided by the UK government backed arms exports ... [and] ... as a result approximately 20% of arms exports [were] paid for by the UK taxpayer'.²⁹ Lastly, governments have fostered the offset of export sales against trade commitments backed or undertaken by national governments.

²⁵ S. Martin, 'Overview of the Theory and Evidence', in S. Martin (ed.), *The Economics of Offsets: Defence Procurement and Countertrade*, (Reading: Harwood Academic Publishers), 1996, p. 31.

²⁶ Adapted from OMB, *Offsets in Military Exports*, Office of Management and Budget, Executive Office of the President, Washington DC, 1988.

²⁷ See <http://www.dti.gov.uk/europeandtrade/strategic-export-control/index.html> accessed 2 December 2007.

²⁸ Thomas Harding, 'Fury as DESO is scrapped', *The Daily Telegraph*, 26 July 2007, <http://www.telegraph.co.uk/money/main.jhtml?xml=/money/2007/07/26/cndeso126.xml> accessed 2 December 2007.

²⁹ C. Havemann, 'Ethical Business Around the World: Hawks or Doves? The Ethics of UK Arms Exports', *Business Ethics*, Vol 7, No 4, October 1998, p. 243; Paul Ingram & Ian Davis, *The Subsidy Trap: British Government Financial Support for Arms Exports and the Defence Industry*, (Oxford and London: Oxford Research Group & Saferworld, 2001).

A third feature is the range of national restraints and international controls that regulate conventional weapons transfers. On the one hand, as Wezeman et al. point out:

Official and publicly accessible data on arms transfers are important for assessing the policies of exporters and importers and for holding to account those who are responsible for those policies. However, making data on arms sales and acquisitions publicly available is a sensitive point for nearly all states. Several global mechanisms for the reporting arms sales and arms acquisitions have been in force since the early 1990s, but transparency remains limited.³⁰

On the other hand, a range of governmental and inter-governmental regulatory mechanisms do exist that are intended to ensure codes of conduct in arms exports, and which impact on government relationships with their key weapons suppliers:

- International measures are in place intended to increase national transparency in arms transfers. These include the UN Register of Conventional Arms (UNROCA),³¹ the EU Eight Annual Report (2006) on the implementation of the EU Code of Conduct on Arms Exports³² and national reports on arms exports.³³
- There are a number of agreements and treaties in place that govern what can and what cannot be transferred and which states can qualify arms as arms recipients. Examples of these include the Non-Proliferation Treaty that dealt with a particular type of weaponry to the arms bans placed on Iraq by the United Nations after the Iraqi invasion of Kuwait in August 1990.
- There are national self-imposed restrictions that individual countries have elected to make. For the

United Kingdom the criteria and policy are overseen by the Department for Business, Enterprise and Regulatory Reform³⁴ and the Foreign and Commonwealth Office publishes an annual 'Strategic Export Control Report'.³⁵

Section 3: Trends in International Arms Sales

3.1 Introduction

There is no single definitive guide to military expenditure. States vary both in their degree of openness and the way in which they calculate expenditure. For some states there is simply no information (e.g. North Korea). For other states there is a question about the difference between the actual and official figures (e.g. People's Republic of China). A further complication has occurred as a result of changes in defence financing in some advanced western countries. Leasing, Public-Private Partnerships and other such agreements have shifted the capital burden from the state to private finance. The result has been a considerable amount of off-balance sheet financing and a situation where only annual instalment fees are shown in the defence budgets. Effectively this has allowed a number of states to defer defence expenditure by spreading the capital costs over the life of an asset rather than have them as upfront costs as has been previous practice. For example, the Future Strategic Tanker Aircraft programme is estimated to cost \$24bn over its 25 year life span which is more than the annual defence budget of all but 9 countries.³⁶ Nevertheless, an examination of the main databases indicates that there is general agreement on the main trends in military expenditure.³⁷

3.2 What are the Main Developments in Global Military Expenditure?

The end of the Cold War brought major changes to the scale and distribution of military expenditure. In the decade that followed, overall arms expenditure

³⁰ S. Wezeman, M. Bromley, D. Fruchart, P. Holton & P. Wezeman, 'International Arms Transfers', *SIPRI Yearbook 2007*, (Oxford: OUP), 2007, p. 413.

³¹ See <http://www.un.org/Depts/ddar/Register/Register.html> accessed 3 December 2007.

³² See <http://www.fco.gov.uk/servlet/Front?pagename=OpenMarket/Xcelerate/ShowPage&c=Page&cid=1014919016078> accessed 3 December 2007.

³³ See <http://www.fco.gov.uk/servlet/Front?pagename=OpenMarket/Xcelerate/ShowPage&c=Page&cid=1007029395474> accessed 3 December 2007.

³⁴ See <http://www.berr.gov.uk/files/file18678.pdf> accessed 3 December 2007.

³⁵ See

<http://www.fco.gov.uk/servlet/Front?pagename=OpenMarket/Xcelerate/ShowPage&c=Page&cid=1007029395474> accessed 3 December 2007.

³⁶ Guy Anderson, 'UK MoD gives FSTA consortium go-ahead to raise private finance', *Jane's Defence Industry*, 1 July 2007.

³⁷ Databases examined include: SIPRI, IISS, Jane's Defence Group and the US State Department.

Region	% Change 1989-98	% Change 1997-2006	Expenditure 1998 in US\$bn at constant 1995 prices	Expenditure 2006 in US\$bn at constant 2005 prices
Africa	-25	51	9	15.5
Americas	-30	53	283	575
Asia, Oceania		41		185
Asia	27		131	
Oceania	6		9	
Middle East	17	57	43	72.5
Europe	-55	10	220	310
World	-34	37	696	1158
Change %	-4.5	3.5		

fell by approximately 34% according to SIPRI (1989-1998).³⁸ By way of contrast the last decade has witnessed an overall increase of approximately 37% (1997-2006).³⁹ This meant that by the early years of the twenty-first century worldwide expenditure topped US\$1,000bn,⁴⁰ equating to approximately 2.5% of the world's gross domestic product. The table above based on SIPRI sources provides an overview of the scale and overall change by geographical region.⁴¹

To summarise, after 1989 there was an overall decrease in relative military expenditure which bottomed out in the late 1990s followed by year-on-year increases. These trends reflected three factors:

1. The internal political dynamic of a state can result in decreases and increases in expenditure as a reflection of domestic electoral considerations. For example, major rises in the US defence budget occurred after President George W Bush entered office. Conversely the collapse of the Soviet Union after 1989 resulted in a major downturn in expenditure across the countries that formerly comprised the Warsaw Pact.
2. The strategic context for states, and more generally for regions, has changed over time. For example, there was a major reduction in general expenditure in the first decade after the Cold War, particularly in

Europe, as governments realised the so-called 'Peace Dividend'. In contrast notable increases to the US defence budget were precipitated following the 11th September 2001 attacks on New York and the Pentagon.

3. Changes in a state's fiscal prosperity can precipitate increases or decreases in relative expenditure. In the case of Saudi Arabia and Russia the rise in oil and gas prices has facilitated a further round of major defence acquisitions over the last two years. In contrast relatively low oil prices from the mid-1990s to the first half of the current decade precluded major defence investment by both states.

It is also apparent that global defence expenditure is dominated by a relative small number of states, and that the US defence budget dominates. The top 20 states in terms of national defence expenditures (current US\$) for 2006 were:⁴² (see page A49)

When these budgets are examined it is noticeable that for the Western countries there has been a major movement towards reducing personnel costs as a means of maximising equipment expenditure. For example, a SIPRI analysis of the expenditure of 18 NATO states that were members of the Alliance between 2000 and 2006 (Iceland is excluded as it has no armed force) shows that equipment costs rose at a far higher rate than personnel costs:

³⁸ SIPRI Yearbook 1999: *Armaments, Disarmament and International Security*, (Oxford: Oxford University Press, 1999), p.270.

³⁹ SIPRI Yearbook 2007: *Armaments, Disarmament and International Security*, Oxford: Oxford University Press, 2007, pp.268.

⁴⁰ SIPRI Yearbook 2007: *Armaments, Disarmament and International Security*, Oxford: Oxford University Press, 2007, pp.268.

⁴¹ SIPRI Yearbook 2007: *Armaments, Disarmament and International Security*, Oxford: Oxford University Press, 2007, pp.268; SIPRI Yearbook 1999: *Armaments, Disarmament and International Security*, (Oxford: Oxford University Press, 1999), p.270.

⁴² SIPRI Yearbook 2007: *Armaments, Disarmament and International Security*, Oxford: Oxford University Press, 2007, pp.310-6.

Country	\$m	Country	\$m
USA	546018	India	24014
UK	61925	Brazil	15638
France	54686	Canada	14837
PRC	51400	Australia	14075
Japan	41702	Spain	12966
Russia	39800	Israel	11737
Germany	38108	Turkey	11248
Italy	30905	Iran	10453
Saudi Arabia	29541	Greece	10091
South Korea	23928	Netherland	10029

This trend is confirmed in various official defence policies. For example, the United Kingdom's 'Delivering Security in a Changing World' placed a good deal of emphasis on shifting costs from personnel to equipment and announced significant reductions in military and civilian staff.⁴³

3.3 Regional Trends in Military Expenditure

Africa

Both North and Sub-Saharan Africa have seen a steady rise in military expenditure over the last decade. In the decade that followed the end of the Cold War the region was split with Sub-Saharan African witnessing a considerable overall fall in defence expenditure and North Africa seeing an increase. Nevertheless, from a global perspective Africa continues to remain a relatively small market and is dominated by requirements for air and land systems. The combined annual defence budget for the region remains less than the annual budget of any of the top 20 spending nations' defence budgets. Moreover, 4 of Africa's 50 countries account for 42% of the region's total expenditure of approximately \$15.5bn per year (constant 2005 prices).⁴⁴

Americas

The biggest changes in this area relate to the US defence budget which continues to dominate both

regional and world military expenditure. To provide perspective, between Fiscal Years 2001 and 2006 the US defence budget has increased by some 53% in real terms and is greater than the sum of the next 20 countries combined. Consequently, the US market acts as the major driver for most arms suppliers and partially explains the level US company acquisitions by various non-US firms. The highest profile was BAE Systems' acquisition of United Defense Industries, then the sixth largest defence manufacturer in the world. The implication was that the US rather than UK government became BAE Systems' largest customer overnight.⁴⁵ BAE Systems has not been alone in acquiring various US subsidiaries, with Thales and EADS following a similar approach.⁴⁶ Moreover, this change in position has allowed these companies to gain greater access to the US defence market leading to a number of high-profile successes, notably Agusta Westland's contract award for EH-101 helicopters for the Presidential flight.⁴⁷

However, the long term sustainability of this budget is questionable as the US national debt continues to rise above \$9.1tr.⁴⁸ Defence inflation in general, the escalating cost of the veteran's budget and the price of the ongoing Global War on Terrorism are all having a major effect.⁴⁹ Experts predict that the US economy is entering a period of financial instability arising from concerns over debt levels, the price of oil and sub-

⁴³ 'Delivering Security in a Changing World: the Defence White Paper', Cm.??, (London: TSO, 2003).

⁴⁴ SIPRI Yearbook 2007: Armaments, Disarmament and International Security, Oxford: Oxford University Press, 2007, p.283.

⁴⁵ 'BAE Systems to buy US rival UDI', BBC Online, 7 March 2005, <http://news.bbc.co.uk/1/hi/business/4324733.stm> accessed 29 November 2007.

⁴⁶ 'Aerospace and Defense Restructuring, January 1985 – December 2005', Defense News, 22 May 2006, pp.18-23.

⁴⁷ <http://www.teamus101.com/news38.cfm>

⁴⁸ <http://www.treasurydirect.gov/NP/BPDLogin?application=np> as at 27 November 2007 accessed 29 November 2007.

⁴⁹ Otto Kreisher, 'Budget office reports war costs could reach \$2.4 trillion by 2017', Congress Daily, 24 October <http://www.govexec.com/dailyfed/1007/102407cdpm2.htm> accessed 27 November 2007.

prime mortgage lending.⁵⁰ Acknowledging the situation President George W Bush confirmed that the current trend in US federal spending is unsustainable in his 2008 budget.⁵¹

All this implies that the currently levels of US defence spending will reduce. Moreover, an increasing proportion of the budget is represented by supplemental expenditure to support the 'Global War on Terror', and thus is not part of the existing long term programme. Bush's successor may well choose an alternative policy to the Global War on Terror or at least scale back the American commitment. Even the costs of a reduced commitment are estimated at \$2.4tr by 2017.⁵² At the same time US military leaders are stating that the war in Iraq is wearing out much of their current equipment and there is a need to recapitalise existing stock. For example, General Schoomaker testified before Congress that the army had a \$17bn shortfall caused by the need to replace equipment worn out or destroyed as part of ongoing operations.⁵³ As a result of this, there are a series of major equipment programmes that look vulnerable to potential cuts and a number of commentators have argued that one or more will have to be axed. It is worth noting that the US Navy has already cancelled the 3rd and 4th Littoral Combat ships.⁵⁴

The picture for rest of the region is mixed. Canada has recently reversed the steady reduction in its defence spending and focus on defending Canada. Instead force levels are increasing, there is additional funding for new equipment and Canada is engaged in projecting military forces as part of coalition operations in Afghanistan.⁵⁵ This has led to a number of procurement decisions to support this, notably the acquisition of 4 C-17 strategic lift aircraft from Boeing,⁵⁶ C-130J Hercules tactical transport aircraft from Lockheed Martin and orders for Chinook heavy

lift helicopters to replace capabilities abandoned several years ago.⁵⁷

Other larger spenders, such as Brazil, have continued gradually to increase their spending. In part, this reflects far greater democratic control and accountability within the region than during the Cold War. This has meant that a number of militaries are now being forced to undertake reform and modernization within a democratic framework with the result they are being subjected to significant financial accountability.⁵⁸

Asia and Oceania

Both regions have continued to witness a steady long term increase in defence expenditure. China and India account for approximately 40% of the region's military expenditure and there are elements of an arms race between the two states. The Chinese budget remains difficult to assess because the vast majority of defence production is conducted indigenous in conditions of secrecy. Estimates vary from the official Chinese figure for 2006 of \$35bn, to SIPRI's estimate of \$49.5bn and the US Defense Intelligence Agency's estimate of \$80-115bn.⁵⁹ Most analysts now agree that the Chinese defence budget exceeds Japan's, but the extent remains contested. Whilst the majority of China's spending has been on domestic suppliers it has also acquired important items of Russian equipment for the air and sea environments as a means of inward technology transfer, and it continues to collaborate with Pakistan on a variety of projects.

India remains a growing power with a large indigenous development and production capability. It has traditionally relied heavily on Russia for the supply of advanced weaponry which it has tended to produce under licence. However, the post-9/11

⁵⁰ 'How to Survive the Credit Crunch and What Stocks to Buy Now', *MoneyWeek*, 29 November 2007, http://info.moneyweek.com/pdf_supplement.php?bbcarn=adwds&bbkid=subprime+market&x=&jtid=2199030&UID=JF++Google&s_id=6&ss_id=6 accessed 29 November 2007.

⁵¹ 'Overview of the President's 2008 budget', p.6, <http://www.whitehouse.gov/omb/budget/fy2008/overview.html>

⁵² Otto Kreisher, 'Budget office reports war costs could reach \$2.4 trillion by 2017', *Congress Daily*, 24 October <http://www.govexec.com/dailyfed/1007/102407cdpm2.htm> accessed 27 November 2007.

⁵³ *SIPRI Yearbook 2007: Armaments, Disarmament and International Security*, Oxford: Oxford University Press, 2007, p.278.

⁵⁴ 'Navy Terminates Fourth Littoral Combat Ship', US Navy website, 1 November 2007, http://www.navy.mil/search/display.asp?story_id=33000 accessed 3 December 2007.

⁵⁵ See 'Canada's International Policy Statement: A Role of Pride and Influence in the World', (Ottawa: Department of National Defence, 2005), http://www.dnd.ca/site/reports/dps/pdf/dps_e.pdf accessed 3 December 2007.

⁵⁶ See http://www.boeing.com/news/releases/2007/q1/070202d_nr.html accessed 29 November 2007.

⁵⁷ http://www.airforce.gc.ca/site/newsroom/crew/2007_02/03_e.asp accessed 3 December 2007.

⁵⁸ *SIPRI Yearbook 2007: Armaments, Disarmament and International Security*, Oxford: Oxford University Press, 2007, p.285.

⁵⁹ *SIPRI Yearbook 2007: Armaments, Disarmament and International Security*, Oxford: Oxford University Press, 2007, p.289; *Military Power of the People's Republic of China 2006*, US Department of Defense, 2006, <http://www.defenselink.mil/pubs/pdfs/China%20Report%202006.pdf> accessed 3 December 2007.

	2000	2006
Personnel	270816	300269
Personnel Change		+11%
Equipment	120609	176828
Equipment Change		+47%

Figures based on constant 2005 US\$

rapprochement in US-Indian relations has potentially opened the Indian market to western suppliers and there is intense international competition for the provision of 126 fighter aircraft to replace the aging MiG-21 aircraft in a deal estimated to be worth some \$10bn.⁶⁰

Japan, South Korea and Australia have continued modernizing their respective armed forces and improve their capabilities. This has involved considerable investment in US equipment by all three states. Both Japan and South Korea remain concerned about the future of North Korea and have responded accordingly, while Australia has played an important role in the global war on terror. This has led to a revision of its defence strategy away from a focus on defending Australia towards an interventionist power projection focus.⁶¹ Significant defence increases have led to an expansion in the size of the armed forces, particularly the army, and some problems absorbing the new capabilities. The long-term continuation of this policy is now doubtful given the recent change in government.

Europe

Overall there continues to be year-on-year increases in defence expenditure, but this masks a much more complex picture. For the majority of the European NATO countries defence spending as a percentage of gross domestic product continues to fall with the NATO average now below its 2% benchmark for all but seven of its members.⁶² Nevertheless, the European members of NATO still have 8 of the top 20 defence spenders amongst their number with the UK and France in the lead in terms of total expenditure. However, this spending level has been insufficient to maintain force numbers and the United Kingdom has

led the way in exploring alternative funding models as a way of offsetting the funding deficit.

Some countries, however, do not conform to this trend with Turkey and Greece maintaining relatively high levels of defence expenditure. More significantly, Russian defence spending is increasing as a result of improvements in the economy brought about by high oil and gas prices.⁶³ The defence budget for 2005 and 2006 represented a 19% and 12% increase respectively.⁶⁴

There continues to be a series of high profiles European defence programmes, although it should be noted that the majority of these date from the Cold War, and a European Defence Agency has been established to bring about greater defence consolidation and efficiency. These programmes include Eurofighter and A400M aircraft, the EH-101, NH-90 and Tiger helicopters, the Boxer wheeled personnel carrier, the Galileo satellite system and various missile programmes. Despite this, the region has witnessed the acquisition of a significant number of its companies by larger US multinationals which have established a significant footprint in the region. For example, Lockheed Martin have acquired a number of firms engaged in developing and building land platforms. These acquisitions have covered virtually all fields of defence with US companies having or holding responsibility for running such diverse areas as dockyards and nuclear facilities.

Middle East

Like Europe, the overall picture of a steady increase in recent years masks a good deal of disparity. Saudi Arabia, Israel and Iran top the region's defence spenders and feature in the world's top 20 list. Saudi Arabia has

⁶⁰ Siddharth Srivastava, 'A US\$10bn scramble for India's fighter jets', *Asian Times Online*, http://www.atimes.com/atimes/South_Asia/IG12Df03.html accessed 29 November 2007.

⁶¹ 'Video Briefing on current issues by the NATO Secretary General, Jaap de Hoop Scheffer', 9 October 2006,

⁶² <http://www.nato.int/docu/speech/2006/s061009a.htm> accessed 3 December 2007.

⁶³ *SIPRI Yearbook 2007: Armaments, Disarmament and International Security*, Oxford: Oxford University Press, 2007, p.294.

⁶⁴ *SIPRI Yearbook 2007: Armaments, Disarmament and International Security*, Oxford: Oxford University Press, 2007, p.294.

consistently spent far more than the other states in the region accounting for approximately 40% of military spending year on year.⁶⁵ The region has, for the last decade, consistently had the highest defence burden spending amounting to an average of approximately 6% of gross domestic product.⁶⁶ However, there are significant estimation difficulties because of a lack of transparency concerning weapons purchases and defence expenditure. Israel, one of the few democracies in the region, conceals the majority of its defence spending and 2006 was the first time that an Israeli government had outlined in public its planned military expenditure for the following year. However, whilst areas of expenditure were explain, such as the cost of constructing the barrier with the Palestinian territories, the government refused to reveal detailed security strategy, force structure or modernization plans.

There is some indigenous production within the region, most noticeably in Israel and Iran, and a number of countries have undertaken licensed production of weapons systems. Israeli firms are ranked 46th (Elbit Systems), 57th (Rafael Armament Development Authority) and 92nd (Israeli Military Industries) and have developed various niche markets.⁶⁷ The remaining states are dependent on the acquisition of major products from overseas with some countries, such as the Gulf States, hire non-national personnel to staff their armed forces. The future of the defence market in the region looks buoyant given the ongoing tension between the various states that look no nearer resolution.

3.4 How has the Industrial Content/ Context of Arms Production and Ownership Changed and Evolved?

An examination of the major manufacturers highlights the dominance of the US and Europe. Mitsubishi Heavy Industries is the highest ranked non-US-Europe and is ranked 23rd with a total defence revenue of \$2055.9m. Indian firms are increasingly beginning to become significant but only in terms of their own growing domestic market.

The table on page A38 shows that the level of defence dependence amongst the top 20 defence manufacturers varies considerable from 2-100%. Overall, the majority of companies are heavily dependent on defence sales for some 70+% of their revenue stream and have stayed in the defence sector as spending, particularly in the US, has risen.

There are various significant changes in this profile compared with a decade ago:

1. The relative size of the top tier 3 companies has increased as a result of mergers and acquisitions. These firms are increasingly looking to take on the profitable role of overall defence project integrators from the US government. Consequently, there is evidence that national defence organisations are increasingly divesting responsibility for support and maintenance to such companies over long-term equipment contracts. On the whole governments have appeared willing to let this happen.
2. Many of these companies have broadened their industrial base beyond aerospace in an attempt to insulate themselves from the vagaries of the arms market. For example, BAE Systems was a relatively minor player in the European land systems market until it acquired Alvis in the UK and United Defence Industries in the USA. This transformed the firm into a major supplier of land systems to the US government, and represented the first major acquisition of a US tier 3 defence contractor by a non-US firm.
3. There has been a considerable rise in the number of service providers, project integrators and private security companies. This reflects a change view in market profitability and at the lower level there have been a number of companies which have grown significantly to cover sectors that were traditionally provided by national armed forces. Examples of this include Halliburton, SAIC, VT Group (40th), Qinetiq (27th) and Bechtel (35th).

3.5 What are the Key Developments in International Arms Transfers?

Context

Any analysis of key developments in arms transfers needs to consider the ebbs and flows of the trade over a number of years. The tables in this section focus on three elements:

1. Top 10 developing nations in 2005 for arms deliveries and agreements.
2. Top 10 leading suppliers in 2005 in terms of arms deliveries and agreements.
3. Total value of arms transfer agreements between 1998 and 2005 highlighting relative amounts and shares of the leading suppliers.

⁶⁵ SIPRI Yearbook 2007: Armaments, Disarmament and International Security, Oxford: Oxford University Press, 2007, p.295.

⁶⁶ SIPRI Yearbook 2007: Armaments, Disarmament and International Security, Oxford: Oxford University Press, 2007, p.295.

⁶⁷ 'Defense News Top 100', *Defense News*, 26 June 2006, p.12 & 14.

Rank	Company	Country	2005 Defence Revenue in US\$m	2005 Total Revenue in US\$m	% of Revenue from Defence
1	Lockheed Martin	US	36465	37213	98
2	Boeing	US	30791	54845	56.1
3	Northrop Grumman	US	23332	30700	76
4	BAE Systems	UK	20935.2	26500.2	79
5	Raytheon	US	18200	21900	83.1
6	General Dynamics	US	16570	21244	78
7	EADS	NL	9120.3	40508.2	22.5
8	L-3 Communications	US	8549.2	9444.7	90.5
9	Thales	France	8523.3	12176.1	70
10	Halliburton	US	7552	20994	36
11	Finmeccanica	Italy	7125.7	12728.1	56
12	United Technologies	US	6832	42700	16
13	Science Application International Corp	US	5400	7792	69.3
14	General Electric	US	3500	149700	2.3
15	Computer Sciences Corporation	US	3368.9	14615.6	23.1
16	DCN	France	3352	3352	100
17	Rolls-Royce	UK	3293.6	11357.2	29
18	ITT Industries	US	3220	7400	43.5
19	SAFRAN Group	France	3074.8	12527.9	24.5
20	ATK	US	2882.0	3217	89.6

Source: 'Defense News Top 100', *Defense News*, 26 June 2006, p.12.

Table 1

	Arms Deliveries to Developing Nations				Arms Transfer Agreements to Developing Nations	
	Leading Recipients in 2005	Current US\$			Leading Recipients in 2005	Current US\$
1	Saudi Arabia	3500		1	India	5400
2	Israel	1700		2	Saudi Arabia	3400
3	India	1600		3	China	2800
4	Egypt	1500		4	UAE	2200
5	China	1400		5	Venezuela	1900
6	Taiwan	1300		6	Pakistan	1700
7	UAE	1200		7	Iran	1500
8	South Korea	600		8	Egypt	1100
9	Pakistan	500		9	Brazil	900
10	Afghanistan	500		10	South Africa	800

Source: SIPRI Yearbook 2007, p.412.

For consistency the statistics from the 2007 SIPRI yearbook were used. Although there is no universal agreement over these statistics and other databases have different amounts they generally show similar trend.

Table 2

Table 3

Analysis

The statistics in the tables above highlight a number of points about Arms Transfers:

- It is clear that a select few nations monopolise much of arms transfer market. The G8 countries (less Canada) have a total share that never drops below 75% (Table 3) and whilst this may vary over time between them the US share in terms of value has been relatively constant at \$11-15bn. This is hardly surprising since with the largest domestic markets these countries have an advantage in terms of production runs and also a technological lead.
- The scale of the market is also significant averaging \$36765m per annum in constant 2005 US\$ (Table 3). This is greater than the annual defence budgets for all except the world's seven highest spenders with only the United States defence budget dwarfing this amount.
- There is no direct correlation in year between arms transfer agreements and in year deliveries. Looking at the snap shot of 2005 in terms of developing countries (Table 1) and also the main suppliers (Table 3) it is quite clear that the level of agreements can significantly fluctuate between different years.
- This reflects the trend in recent years towards recipients buying packages of equipment often including the support element. This means that in general companies are being contracted to provide the full through-life cost of an asset and as a result individual state transfer agreement totals vary significantly year on year whilst their actual

Table 2

	Global Arms Deliveries				Arms Transfer Global Arms Transfer Agreements	
	Leading Recipients in 2005	Current US\$			Leading Recipients in 2005	Current US\$
1	United States	11552		1	United States	12758
2	United Kingdom	3100		2	France	7900
3	Russia	2800		3	Russia	7400
4	France	1600		4	Ukraine	2800
5	China	900		5	Spain	2200
6	Germany	600		6	China	2100
7	Israel	600		7	Austria	2000
8	Canada	500		8	Germany	1500
9	Sweden	400		9	Italy	1400
10	Spain	400		10	Israel	1100

Source: SIPRI Yearbook 2007, p.412.

deliveries are more consistent. Note, for example that the United Kingdom was the second largest supplier of arms in 2005 but was not even in the top 10 for arms transfer agreements signed in 2005. In fact, in terms of arms transfer agreements signed the United Kingdom fluctuated from £319m in 2003 to £6612m in 2004 (Table 3) with 2003 representing over 40% of the cumulative total for the 8 year period. The United Kingdom was not alone in such fluctuations. France had a similar level of change between 2002 and 2005 (Table 3).

- The statistics for 2005 also show that the arms trade is a truly global market. Comparisons between the leading developing nations recipients in terms of deliveries and agreements shows changes over time.

Section 4: Problems of Dual Use Technology Transfer

4.1 Defining the issue

There are a series of problems associated with dual use technology transfers. To consider them it is first useful to understand what is meant by the term technology. A standard definition is that technology:

comprises the ability to recognise technical problems, the ability to develop new concepts and tangible solutions to technical problems, the concepts and tangibles developed to solve technical problems, and the ability to exploit the concepts and tangibles in an efficient way.⁶⁸

⁶⁸ Autio, Erko & Laamanen, Tomi, 'Measurement and Evaluation of Technology Transfer: Review of Technology Transfer Mechanisms and Indicators', *International Journal of Technology Management*, vol.10, no.7-8,1995, pp.643-64.

Table 3: Value of Global Arms Transfer Agreements and Market Share, 1998-2005 (constant 2005 US\$m - % in italics)

	1998	1999	2000	2001	2002	2003	2004	2005
Total	35682	41823	36319	34844	31658	29252	40207	44158
Russia	2678	5470	7528	6187	6128	4684	5579	7400
	<i>7.5</i>	<i>13.1</i>	<i>20.7</i>	<i>17.8</i>	<i>19.4</i>	<i>16</i>	<i>13.9</i>	<i>16.8</i>
US	11513	13880	12923	13019	14367	15518	13244	12758
	<i>32.1</i>	<i>33.2</i>	<i>35.6</i>	<i>37.4</i>	<i>45.4</i>	<i>53</i>	<i>32.9</i>	<i>28.9</i>
UK	2435	1784	695	675	766	319	6612	2800
	<i>6.8</i>	<i>4.3</i>	<i>1.9</i>	<i>1.9</i>	<i>2.4</i>	<i>1.1</i>	<i>16.4</i>	<i>6.3</i>
France	7670	2021	5328	4725	1313	2129	2169	7900
	<i>21.4</i>	<i>4.8</i>	<i>14.7</i>	<i>13.6</i>	<i>4.1</i>	<i>7.3</i>	<i>5.4</i>	<i>17.9</i>
Germany	6087	4756	1390	1350	328	639	620	1400
	<i>17</i>	<i>11.4</i>	<i>3.8</i>	<i>3.9</i>	<i>1</i>	<i>2.2</i>	<i>1.5</i>	<i>3.2</i>
Italy	730	832	232	1350	328	639	620	1400
	<i>2</i>	<i>2</i>	<i>0.6</i>	<i>3.9</i>	<i>1</i>	<i>2.2</i>	<i>1.5</i>	<i>3.2</i>
All other European	2313	6897	4749	3375	4815	2129	6921	5900
	<i>6.4</i>	<i>16.5</i>	<i>13.1</i>	<i>9.7</i>	<i>15.2</i>	<i>7.3</i>	<i>17.2</i>	<i>13.4</i>
China	852	3686	579	1237	438	532	723	2100
	<i>2.4</i>	<i>8.8</i>	<i>1.6</i>	<i>3.6</i>	<i>1.4</i>	<i>1.8</i>	<i>1.8</i>	<i>4.8</i>
Others	1583	2497	2896	2925	2408	1703	2686	2400
	<i>4.4</i>	<i>6</i>	<i>8</i>	<i>8.4</i>	<i>7.6</i>	<i>5.8</i>	<i>6.7</i>	<i>5.4</i>

Source: SIPRI Yearbook 2007, p.412.

Such a definition provides a framework for appreciating a range of skills, materials, artefacts and knowledge that can be used to develop solutions that can satisfy either a civilian or military requirement. In other words, it is more than simple hardware. It has associated with it knowledge and information which may form part of it or form a separate distinct element. For example, the civilian airliners became a weapon on 11th September 2001 when their control was put in the hands of individuals who wished to target the World Trade Center etc. and had learnt how to fly those aircraft to their targets. All the elements, the aircraft and pilot training were completely civil until they came together with the intent to commit mass murder at which point they became a guided weapon.

Dual-use is a term that historically has tended to refer to the proliferation of weapons of mass destruction. As the example above shows, it is actually a much wider issue. It is now used in politics and diplomacy to refer to technology which can serve both civilian

and military purposes and one of the key points to note is that there may be a time differential between the two. In other words, it is a technology that at one point in time is used with a primary civil or military end in mind and which can subsequently transfer to the other.

4.2 Types of Dual-Use

When considering dual-use technology it is necessary to recognise that it takes various forms. Note that most of the examples generally cited in the literature refer to hardware but the issues of dual-use are also generally equally applicable to knowledge and information. For the purposes of this study the focus is on the transfer of civilian technology to the military sector. Looking at the situation from the suppliers' point of view we can identify three categories of technology:

- Technology which when used has, as a by-product, elements that have potential military application.

A good example of transfer from the military to the civil world is the global positioning system (GPS). It was designed to maximise accuracy in the delivery of weapons and for military units to locate themselves. It is now used to help us navigate our cars. The traditional civilian to military example cited in most of the literature relates civilian nuclear reactors using for electricity generation etc. Some of these reactors have, as a by-product, plutonium which can be used as the basis of a nuclear weapon. This example represents one extreme of the by-product challenge – a by-product which can be used to develop a relatively sophisticated weapon. However, this example can be taken further. At the other end of the spectrum of by-products lie the various waste products from hospitals. Some of these are radioactive and could potentially be used to construct a so-called dirty bomb where radioactive materials are packed around conventional explosives. This is then exploded and the radioactive elements scattered over an area which would need decontamination. For a terrorist organisation looking to disrupt the economy of a state such a weapon could be quite appealing as a method of paralysing element of a state's critical infrastructure. Such transfers of technology would assume that the transferee would adapt the technology and the transferor may be completely unaware of the change in use.

- Technology developed that whilst designed for civilian purposes can be converted to military use. For example, the existing air-to-air refuelling tanker aircraft of the Royal Air Force comprise a mixture of VC-10 and Tristar aircraft all of which were initially sold as civilian airliners and acted as such.⁶⁹ Subsequently, they were acquired by the Ministry of Defence and converted into their new roles. There are a variety of types of equipment that fall into this classification including aircraft, helicopters, ballistic missiles designed for space exploration, vehicles and computers. In this example the transferor or transferee may be involved in adapting the technology and thus the transferor may be completely unaware of the intended military application of the technology.
- Technology that has an interchangeable civilian and military use. Such equipment can range from advanced IT such as computers and mobile phones to relatively low technology areas such as peroxide used for dyeing hair or explosives which have both a civilian (mining) and military use. In this case either

transferor or transferee may make any adaptations and thus for the transferor understanding the reasoning behind the acquisition becomes vital.

4.3 Industry and the Recipient's perspective

For industry the situation is becoming more complicated by this interchangeability of technology. Industry often has research centres that feed into the civilian and military sectors. This makes differentiating civilian and military processes problematic. To understand this it is illuminating to examine technology transfer from the perspective of the recipient. In this case the technology transferred can be thought of in a number of ways:

- Straight transfer with no adaptation needed. In this case the transferor knows exactly what is being acquired. The issue when it is dual-use is what is the reason for the acquisition? The problem of end use is that an application for civilian use now does not prevent a subsequent military use later by the transferee of another.
- Straight transfer from more than one source, the collective elements providing a capability. In this case the transferor may be unaware that he is contributing to the development of a military capability. One of the main problems is that the transferor may well only have a limited part of the picture. The case of Matrix Churchill and Iraq's Supergun highlighted that only a few people actually knew the full story.
- Transfer from one of more sources with adaptation undertaken by the recipient. The transferor is unlikely to be aware of the consequences of the transfer. The key here is an understanding of the intent of the recipient.
- Transfer from one of more sources with adaptation undertaken by one of the transferors. In this case unless the transferor undertakes the adaptation, or is aware that another company is doing the adaptation, then it is unlikely to be aware.

4.4 Management of Dual-Use Technology

The regulation of dual-use technology transfer addressed at the national and the international levels. In both contexts there are two types of control. First, there are controls relating to specific technologies such as nuclear materials. Second, controls are imposed on specific countries. For example, as part

⁶⁹ <http://www.raf.mod.uk/equipment/tankerandtransport.cfm> accessed 28 November 2007.

of the EU sanctions against Iran there is a specific list of dual-use items (Regulation 423/2007) above and beyond the general list (Regulation 1334/2000) of products requiring export approval.⁷⁰

At the national level most developed industrialised states impose controls on certain types of designated dual-use technologies which are intended to restrict the export of certain commodities without explicit government permission. For some areas this is straight-forward – the sale of a fighter aircraft to a country is clear. In others it is not and the focus tends to be on equipment rather than knowledge.

There are also a number of international agreements as well as regional organisations that have their own dual-technology controls, as well as several treaties.⁷¹ For example, the European Commission breaks down dual-use technologies into 10 categories:⁷²

Category 0	Nuclear Materials, Facilities and Equipment
Category 1	Materials, Chemicals, Micro-organisms and Toxins
Category 2	Materials Processing
Category 3	Electronics
Category 4	Computers
Category 5	Telecommunications and Information Security
Category 6	Sensors and Lasers
Category 7	Navigation and Avionics
Category 8	Marine
Category 9	Propulsion Systems, Space Vehicles, Related Equipment

With both national and international actors involved in monitoring dual-use technology the area becomes quite complicated for companies with a worldwide portfolio. It is also clear the level of monitoring and enforcement is also variable and there is no single unified list of restricted export technologies.

Section 5: Government, Industry and the Apportionment of the ‘Moral Hazards’ of Arms Transfers

5.1 Introduction

In summary we have argued thus far that:

- Major defence contractors and national

governments have an inherently close relationship when it comes to DIB policy and meeting domestic procurement needs.

- Supplier government and major defence contractors assume mutual gains and imperatives for arms transfers and so do recipient states. Supplier governments control and regulate arms transfers, and may provide significant subsidies to firms to achieve wider national economic and politico-military policy objectives.
- Recipient governments can perceive a mutual benefit with the supplier company and supplier country from the import of weapons.
- Recipient governments are expecting through-life support of contracts which can last a number of decades. Thus governments and the boards of companies will have their policy options limited by the decisions of their predecessors.
- The trend has been for arms transfers to remain a significant feature of defence-industrial activity, though the content of export markets continues to change and evolve.
- Dual-use technology presents a problem because it is a ‘grey area’ for government and industry that falls between normal civil and dedicated military exports.
- The monitoring of Dual-Use technology has traditionally focused on hardware. However, this is beginning to change and there are now concerns about intellectual property.

On the basis of this analysis we now assess the ‘moral hazards’ confronting industry and governments in arms transfers, and how these hazards can be assigned between industry and government.

5.2 Arms Transfers and the Ethical Debate

Allocation of ‘moral hazards’ has to be addressed against the backdrop of a series of influential ethical and practical concerns about the arms trade that provide part of the political context in which this issue is viewed. These concerns will reflect on individual deals as well as general patterns of trade. These concerns may be in prospect, reflecting

⁷⁰ See http://ec.europa.eu/trade/issues/sectoral/industry/dualuse/index_en.htm accessed 29 November 2007.

⁷¹ For the United Kingdom the list is available via <http://www.berr.gov.uk/files/file42587.pdf> accessed 29 November 2007.

⁷² See <http://www.berr.gov.uk/europeandtrade/strategic-export-control/legislation/control-lists/page40521.html> accessed 29 November 2007.

anxieties about the impact of proposed transfers, or in retrospect, comparing actual practice with claims made when transfers were first proposed. Events can therefore reinforce or undermine transfer decisions.

Concerns over the trade can be sub-divided into economic and politico-military categories.⁷³ Economic issues can be summarised as follows:

- **The value of arms transfer to suppliers.** The economic implications of UK arms exports policy remains contested.⁷⁴ Criticism has emerged about the financial implications of UK arms transfers. Some studies suggest that British government export subsidies including, inter alia, export promotion policies and offsets, outweigh sales revenues.⁷⁵ Others claim that reliance on arms exports to sustain manufacturers has been costly and inefficient when compared to relying more on overseas suppliers for the UK's own defence equipment needs.
- **Impact on economic development in the recipient state.** It is often suggested that arms imports are rarely in the best interests of many of the recipients as they represent a drain on scarce resources. It was thus argued during the 1990s that, 'According to the UN a mere 12% of Third World military spending would end severe malnutrition, provide primary healthcare, immunise children and provide safe water for all. One fifth of current Third World debt can be attributed to loans linked to arms sales in the 1970s'.⁷⁶
- **The cost of copying and retransfers.** In authorising the transfer of weapons systems, supplier governments and firms risk a situation where the recipient may transfer purchases to a third party, or enter the market itself with copies. The net effect can be increased competitiveness in export markets and a loss of original supplier market share as a result of under-cutting by its arms transfer recipients.

Areas of politico-military concern are as follows:

- **Humanitarian.** The claim is frequently made that the spread of arms around the globe fuels rather than dampens conflicts. For example, Havemann states that:

'Violent conflicts, fuelled by irresponsible weapons sales, destroy the lives of millions of people around the world. These conflicts kill civilians, cause refugee crises, destroy physical and social infrastructure, agriculture and development programmes'.⁷⁷
- **Creation of security instability.** It is often suggested that arms transfers promote regional arms races because states in conflict with arms recipients respond by procuring additional military capability. This 'action-reaction' behaviour neutralises security benefits as the arms transfer recipient is no better off. Moreover, arms transfers can have undesirable social impacts in recipient states that may include, for example, domestic instability and increased political interference of the military in society.
- **Limitations of 'leverage' and negative impact on supplier-recipient relations.** The claim that arms transfers have increased UK influence and leverage has been challenged empirically on the grounds that importers have been 'able to choose from a number of arms suppliers, freeing them away from dependence on a single arms supplier'.⁷⁸ There are also reputational risks for supplier governments and firms dealing with different business cultures and political systems.
- **Problems of end-use.** A frequently cited concern is the risk that arms supplied on the assumption they will be used for national defence are actually employed for internal repression. Amnesty international claims that 100 states practise political repression and systematic torture. Other research estimates that 68 per cent of UK arms

⁷³ Main headings derived from C. Catrina, *Arms Transfers and Dependence*, (New York: Taylor Francis), 1988.

⁷⁴ See, for example, Paul Ingram & Ian Davis, *The Subsidy Trap: British Government Financial Support for Arms Exports and the Defence Industry*, (Oxford and London: Oxford Research Group & Saferworld, 2001).

⁷⁵ See S. Martin, 'The Subsidy Savings from Reducing Arms Exports', *Journal of Economic Studies*, Vol 26, No 1, 1999, pp. 15-37.

⁷⁶ Cited in C. Havemann, 'Ethical Business Around the World: Hawks or Doves? The Ethics of UK Arms Exports', *Business Ethics*, Vol 7, No 4, October 1998, p. 240.

⁷⁷ C. Havemann, 'Ethical Business Around the World: Hawks or Doves? The Ethics of UK Arms Exports', *Business Ethics*, Vol 7, No 4, October 1998, p. 242.

⁷⁸ P. Eavis & O. Sprague, 'Does Britain Need to Sell Weapons?', in J. Gittings & I Davis, *Britain in the 21st Century: Re-Thinking Defence and Foreign Policy*, (Nottingham: Spokesman), 1996, p. 128.

transfers in the 1990s were to regimes with poor human rights records.⁷⁹ Nigeria, Iraq, Indonesia and Saudi Arabia have all been identified as perpetrating systematic human rights abuses, yet they have been major recipients of UK arms transfers. This reflects an inherent difficulty in differentiating weapons systems that can only be used for national defence against an external enemy rather than also for internal repression. The dilemma for supplier governments and firms is compounded because the majority of contemporary conflicts are intra-state and so imported weapons are often end up in use in civil wars and insurgencies.

- **Issues connected with delivery.** Concerns relating to arms exporters under this heading are five-fold. First, supplier governments and firms incur the potential or actual political costs of regime change and the risk they will be identified with ‘undesirable’ or oppressive regimes (‘undesired identification’). For example, the UK government supplied arms to the Shah of Iran, only for the Ayatollah to turn against the West after the Iranian Revolution. Second, there are potential security impacts as the supplier loses control of exported technologies, which could include recipient retransfers or capture and use of weapons against the supplier’s interests. An example here was the USA’s inability to retain control of anti-aircraft weapons lent to the Mujaheddin in Afghanistan, which ended up in Iran. Third, there is the risk of involuntary supplier involvement in conflict because of the presence of its nationals in the recipient country supporting arms transfers arising either from military invasion of the local social impacts of an influx of foreign technical personnel. Fourth, there is a risk that UK armed forces are endangered by ‘irresponsible’ arms exports. European armed forces have faced weapons supplied by their own governments in Somalia, Rwanda, Bosnia and Iraq.⁸⁰ As the Scott Report highlighted, after UK companies aided the development of Iraq’s military capabilities British forces faced domestically-produced equipment during Operation Desert Storm.⁸¹ Finally, there are the potential adverse security impacts for suppliers arising if arms recipients ‘indigenise’ transferred weapons technology and develop their own capability to undesirable third-parties.

5.3 The Hazards of Arms Sales

We have been asked to identify problems rather than provide solutions. Our analysis does, however, suggest a way of thinking about the problem. First, there are issues that confront any business with regard to meeting legal and regulatory obligations. In pursuing any sale it might be considered unacceptable to provide hidden subsidies, misrepresent the product and use illicitly acquired intelligence or bribes to help secure an order. However, defence exports are unique because:

‘There is a fundamental conflict between the desire to generate profits from selling the core products of the business and the ethical reasons for not promoting instruments capable of inflicting widespread suffering. Companies involved in manufacturing and trading arms find themselves in a particularly difficult position in trying to reach a balance between the two points’.⁸²

In essence, the products are geared to organized violence. They are designed to cause death, pain, destruction and suffering. That does not mean that all sales result in death, pain, destruction and suffering. Armed forces are maintained for purposes of defence and deterrence, and if they succeed then these human costs may be prevented and the better they are, to the extent they are effective, they can limit damage. Indeed, without national means of defence human costs may either become more likely or else only be prevented through dependence on a foreign power. If countries are attacked then armed force may be the only way of resisting aggression or securing liberation from occupation.

So while it may be the case that arms sales contribute to a regrettable distortion of international priorities and add to the dangers of instability, it may be difficult to explain why any particular transaction contributes more than another to this state of affairs. If a heavily-armed world provides the context in which states must view their national security, then withholding arms from a particular state may be both unreasonable and dangerous, because it may add to the risk of that particular state being victimized and might increase the risk that more powerful states will have to come to its aid (thereby creating a risk of wider conflict).

⁷⁹ P. Eavis & O. Sprague, ‘Does Britain Need to Sell Weapons?’, in J. Gittings & I Davis, *Britain in the 21st Century: Re-Thinking Defence and Foreign Policy*, (Nottingham: Spokesman), 1996, p. 128.

⁸⁰ C. Havemann, ‘Ethical Business Around the World: Hawks or Doves? The Ethics of UK Arms Exports’, *Business Ethics*, Vol 7, No 4, October 1998, p. 243.

⁸¹ See D. Miller, ‘The Scott Report and the Future of British Defense Sales’, *Defense Analysis*, Vol 12, No 3, 1996, pp. 359-69; and, D. Miller, *Export or Die: Britain’s Defence Trade with Iraq*, (London: Cassell), 1996.

⁸² G. Maitland, ‘The Ethics of the International Arms Trade’, *Business Ethics*, Vol 7, No 4, October 1998, p. 203.

Governments therefore tend to identify criteria against which they discriminate between appropriate and inappropriate arms sales. Arms sales are likely to be deemed unacceptable if they:

1. Serve aggressive purposes, including the intimidation or extortion of opponents;
2. Trigger an arms race, by requiring potential adversaries to match newly acquired capabilities;
3. Are directed towards domestic rather than external opponents and are used to suppress democratic and peaceful forms of political expression.
4. Create a risk of transfer to third parties or fall into wrong hands in the event of civil war or coup.
5. Create an unmanageable debt and distort economic prospects of recipient.

Recipients may also have concerns about suppliers:

1. Arms suppliers will gain significant intelligence about their customers' defence needs, capabilities and infrastructure.
2. At times of crisis suppliers may hand over mission-critical information on systems they have supplied to the enemies of arms recipients (for example the French provision of information on Mirage to the UK during the Falklands conflict).
3. Supplying firms may be prevented from providing spare parts or ammunition (US to Iran during its war with Iraq).
4. Suppliers may seek to limit the flexibility of recipient use, for example by prohibiting recipients from employing weapons against internal threats or insisting on recipient support for their allies.

Suppliers must therefore be viewed as potential intelligence and security risks.

Companies are apt to get caught between their national governments and potential customers on aspects of the arms transfers that stem less from intelligence/security considerations and more from the fact that states are their customers:

1. There can be pressure to deliver to a potential foreign customer before deliveries are made to the national customer;
2. The credit-worthiness of customers may require government to provide guarantees or support offset deals;
3. Normal practice in the recipient country, for example in relation to the use of agents to make introductions to key ministers, and other forms of 'commissions', may contradict national laws in the supplier state.

4. Awareness of competition from other suppliers, and considerations of whether this competition is on price and quality or also on the conditions of sale and the tolerance of 'ambiguous' business practices.

Lastly it should be noted that transnational companies or joint ventures may require dealing with quite different sets of regulations and political concerns, and also competition for roles in research, development and manufacture.

5.4 Managing the Hazards

To consider how companies might cope in this type of market place we can start with the following six premises.

Premise 1: There is a 'moral division of labour' between supplier governments and their exporting firms.

Premise 2: Governments decide *to whom and in what quantities* firms can transfer defence equipment to other states, on both a case-by-case basis and through their commitments to international and national export regulation frameworks to which they subscribe.

Premise 3: Firms decide *how to conduct arms transfers* within the contract-specific framework determined by governments. It is within this framework that the business ethics policies and practices and the stated values and behaviours of companies are applied. This distinction is not always straightforward for the framework set by a customer government may conflict with business policies and create opportunities for bribery and other forms of corruption, possibly deliberately. This creates questions of whether just to go along with customer framework, whether to abandon potential business, or whether to attempt to change framework, perhaps working with other companies, national governments or international bodies.

Premise 4: when things 'go wrong' 'moral hazard' risks/liabilities reside with government in the following areas:

- Post facto problems caused by weaknesses/ loopholes in national regulatory arms transfer frameworks.
- Post facto problems caused by particular governments adopting 'minimalist' positions on international arms transfer control regimes.
- Cases where national political expediency has

ignored national or international arms transfer norms and frameworks.

- Problems arising from unforeseen end-use and delivery.

Premise 5: when things ‘go wrong’ ‘moral hazard’ risks/liabilities reside with firms in the following areas:

- Deliberate non-compliance with national and international regulations;
- Business practices that are illegal, including in the supplier state (e.g. bribing foreign government officials);
- Working with local agents or sub-contractors whose own business practices do not meet acceptable standards, disclosure of which may taint particular transfers.
- Lack of ethical business practice policies.

One difficulty with these issues is identifying whether commissions or facilitation payments have led to undue influence or are just a means of getting access to the potential customer’s procurement process.

Premise 6: at all times companies are accountable to their national governments rather than to recipient governments. They should therefore not agree to conditions that they cannot keep should national policy change, or at least acknowledge their dependence on national policy when making commitments in good faith.

We suspect that these broad parameters would be generally agreed. The main ethical challenges will be in how aspects of this framework are interpreted in particular cases (for example what constitutes bribery).

Further, ethical dilemmas for companies will arise in situations where they have choices on how to behave. We would suggest that these choices are likely to result from the sort of privileged information that may become available to a company during the course of a negotiation.

First, companies may come across evidence (for example statements of the customer’s needs) that contradicts the official line on intended uses of goods and services being purchased. This can put a company in a compromised position. It can be recalled that one reason why the government was keen for Matrix Churchill to maintain a supply relationship with Iraq, even though this could involve breaking the rules, was because it could be a valuable source of intelligence on exactly what Iraq was up to. If we stay on the example of Iraq, during the 1980s a

number of chemical companies received orders for chemicals that, to them, only made sense in connection with a chemical weapons programme. They therefore refused to supply the products and so informed their governments. In response Iraq sought to disguise its orders more carefully. Nonetheless it is clear that other suppliers were less careful and simply refrained from asking awkward questions. It may be that claims on end use are contradicted by evidence that the notional customer has no interest or capacity to make use of the product, and it therefore becomes a reasonable presumption that the true customer is elsewhere.

Thus the process of acquiring knowledge about the customer creates potential issue of acting as an intelligence agency, and betraying the client’s trust, or else, respecting confidences but then withholding information relevant to national security.

The issue here is the extent to which the company should investigate claims made by the client or follow up apparent untruths, inconsistencies and misrepresentations, or just take everything it is told at face value. The more it is in a privileged position to get information that is not available to the national governments the more these issues become important. Only when the government and the company are both working from the same knowledge base will the responsibility lie mainly with government and there is no need for the company to try to second guess.

The second choice a company has is whether to act to change government guidelines or policies with regard to particular cases in order to secure particular orders. This may effectively involve acting as an advocate of the customer, playing down apparently objectionable aspects of its behaviour and exaggerating the strategic/security as well as employment and trade benefits to the UK. To what extent, therefore, is it legitimate, for a company to lobby on behalf of another governments’ security claims in order to acquire potentially lucrative orders or to seek reduce or mitigate the impact of the national regulatory framework, or even adherence to internationally agreed norms and treaties?

In addition, might it be possible for a transnational company or joint venture, to shop amongst governments with some potential stake in a product to try to place the transaction in the most favourable jurisdiction. It might be easier to get a European rather than an American government, for example, to agree sales of certain types of equipment to certain Arab countries.

In sum, the overall framework for policy and key strategic judgements are for national governments. So long as they are acting within this framework companies may feel that they have no special ethical case to answer. They may still suffer reputational risks through association with unpopular policies. Companies for whom defence is a minor part of their overall business may well feel that this association is not worth the commercial benefits, or that the defence world is sufficiently unfamiliar for them not to be sure what counts as normal and acceptable. Even companies dependent upon defence sales will be well aware of the reputational risks feel that they can only be managed so long as they stick close to government policies. We have however identified areas related to interpretation, the acquisition and disclosure of sensitive information, and lobbying, which require further investigation as ethical issues. Lastly we would emphasise that the nature of the business and the transactions required means that companies must be sensitive at all times to a number of politico-strategic issues. In the end the fundamental moral justification for companies working in the defence business is that they are net contributors to national security.

Appendix H

Summary of the roundtable seminar

6 February 2008
Royal Horseguards Hotel,
One Whitehall Place, London

Contents

- H-1 Agenda
- H-2 List of Attendees
- H-3 Summary

ROUNDTABLE SEMINAR

Ethical Practices for Global Businesses & their application by Defence Contractors in key areas of ethical risk

Wednesday 6 February 2008, 13.00-18.00
Royal Horseguards Hotel, One Whitehall Place,
River Room, London

Chairman: Lord Robertson of Port Ellen

H1: AGENDA

- 13.00 Buffet Lunch – Meston Room
- 13.45 **Introductions & Opening Remarks – River Room**
(Host: Professor Sir Lawrence Freedman)
(Chairman: Lord Robertson)
- 13.50 **Good ethical business practice by global companies**
A benchmarking study by the Institute of Business Ethics
(Simon Webley, Head of Research IBE)
- 14.05 *Plenary discussion:* Chairman, Lord Robertson

“What are the ethical business practices that would be expected from a global company?”
- 15.35 Tea/Coffee – Meston Room
- 15.50 **Analysis of key ethical risk areas for Defence Contractors**
Paper by Professor Sir Lawrence Freedman, Professor Matt Uttley
and Dr Andrew Dorman, Department of War Studies, King’s College
(Professor Sir Lawrence Freedman)
- 16.05 *Plenary discussion:* Chairman, Lord Robertson

“How should these practices be applied by Defence Contractors particularly in key areas of ethical risk for them, and the role Governments and others can play?”
- 17.35 *Summing-up*
(Chairman, Lord Robertson)

H2: List of Attendees

First Name	Surname	Title	Organisation
Lord Robertson		Chairman	former UK Secretary of State for Defence and Secretary General, NATO
Professor Sir Lawrence Stephen	Freedman	Host	King's College London
Lionel	Banham	Managing Director	Rockwell Collins UK Ltd
Martin	Barber	Editor	The Financial Times
Jermyn	Broadhurst	Chief Executive	Marshall Aerospace
Andrew	Brooks	Director, Private Sector Programmes	Transparency International
Dr John	Cahn	Chief Executive	UK Trade & Investment
	Chipman	Director-General, Chief Executive	The International Institute for Strategic Studies
Professor Michael	Clarke	Director	Royal United Services Institute
Patrick	Crawford	Chief Executive	Export & Credit Guarantee Department
Tim	Cullen	Managing Director	Tim Cullen Associates
Douglas	Daft	Committee Member	Woolf Committee
John	Doddrell	Director	Export Control Organisation; Dept for Business Enterprise & Regulatory Reform
Dr Andrew	Dorman	Senior Lecturer	King's College London
Philippa	Foster Back	Committee Member	Woolf Committee
François	Gayet	Secretary General	Aerospace & Defence Industries of Europe
Michael	Hartnall	Non-Executive Director	BAE Systems plc
John	Howe	Vice Chairman	Thales UK
Sir Bill	Jeffrey	Permanent Under Secretary	Ministry of Defence
John	Millen	Policy Director	Defence Export Service Organisation
Peter	Montagnon	Director	Association of British Insurers
Dr Robin	Niblett	Director	The Royal Institute of International Affairs
Dick	Olver	Chairman	BAE Systems plc
Professor Mark	Pieth	Professor of Criminal Law (Chairman OECD Working Group on Bribery)	University of Basel
Mark	Pyman	Project Director Defence against Corruption	Transparency International UK
Steven	Shaw	Deputy General Counsel (Contractor Responsibility)	US Air Force
Matthew	Symonds	Industry Editor	The Economist
Baroness	Symons	Non-Executive Director, British Airways	former UK Minister of State Defence Procurement
Ian	Tyler	Chief Executive	Balfour Beatty plc
Professor Matt	Uttley	Dean of Academic Studies	King's College London
François	Vincke	President	International Chamber of Commerce
Sir David	Walker	Committee Member	Woolf Committee
Simon	Webley	Research Director	Institute of Business Ethics
Lord Woolf		Chairman	Woolf Committee
Sir Robert	Worcester	Chairman	Ipsos MORI
Observers			
M J 'Alex'	Alexander	Attorney	US Air Force – General Counsel's Office
Dr Debbie	Allen	Director, Corporate Responsibility	BAE Systems plc
Philip	Bramwell	Group General Counsel	BAE Systems plc
Rory	Fisher	CEO's Chief of Staff	BAE Systems plc
Matthew	Fletcher	Adviser (Powerscourt Media)	Woolf Committee
Dr Richard	Jarvis	Secretary	Woolf Committee
Martha	LaCrosse	Head of Chairman's Office	BAE Systems plc

H3: Summary of the discussion at the Roundtable Seminar

Introduction

King's College London, on behalf of the Woolf Committee, hosted a seminar on 6 February 2008 involving senior representatives from industry, academia, non-governmental organisations, think-tanks, the civil service and politics to reflect on how the defence industry should engage in business within the international market. The group contained both British and international representatives. The seminar was conducted under Chatham House Rule which is as follows:

When a meeting, or part thereof, is held under the Chatham House Rule, participants are free to use the information received, but neither the identity nor the affiliation of the speaker(s), nor that of any other participant, may be revealed.¹

It was, however, agreed that a general report on the seminar's main conclusions would be provided accompanied by list of those present (H-2).

The discussion was divided into two parts based on the following questions:

1. *"What are the ethical business practices that would be expected from a global company?"*
2. *"How should these practices be applied by Defence Contractors particularly in key areas of ethical risk for them, and the role Governments and others can play?"*

To facilitate this discussion both parts were preceded by presentations based on the findings of the two studies previously commissioned by the Woolf Committee (reproduced in full at Appendices F and G of the Woolf Committee Report).

In addition, to help provide context some findings from Ipsos/MORI surveys on the perceptions opinion formers hold on the reputations of global companies were highlighted.

Part 1 – "What are the ethical business practices that would be expected from a global company?"

Simon Webley, Head of Research, Institute of Business Ethics, addressed the first question. His study drew on research concerning ten sample multinational companies from around the US, UK and continental Europe covering a variety of industrial sectors. The study looked at three open source documents for each: Codes of Ethics, Annual Reports and Corporate Responsibility Reports.

The main purpose of the codes is to give guidance to all staff on how to uphold the company's core ethical values in day to day business. The code applies as much to those in the boardroom as to those who work on the shop floor. It was clear that overall good practice on the implementation of a values and ethics programme requires more than this, including a culture of adherence with a clear structure of reporting breaches, a system for disciplining those in breach of these codes and the engagement of a company's suppliers, joint venture partners, etc. in the code. Company policies generally applied to agents, consultants and anyone else who represented the company in any capacity.

It is up to managers both to implement the code and act as appropriate role models of good ethical practice. What was less clear from these various reports was whether the culture was truly embedded. Companies are reluctant to disclose their relative success.

One important difference between US companies and others was in the use of facilitation payments². For UK companies such payments are illegal anywhere in the world and are not tolerated. Another difference between US and UK companies concerns political payments, reflecting the variations in political system. The key point here is that there are differences between national approaches about which multinational companies need to be aware and have policies.

The study examined more detailed practices covering five of the originally sampled companies. This showed variations in the measures taken to ensure that staff followed ethical policies. There were few examples of benchmarking against external standards as these were

¹ <http://www.chathamhouse.org.uk/about/chathamhouserule/>

² Facilitation payments – or money paid to local officials to accelerate bureaucratic procedures. In the past, governments have overlooked facilitation payments, assuming that they were simply unavoidable, a necessary part of doing business abroad. Facilitation payments were exempted from the Foreign Corrupt Practices Act (FCPA) – the world's first extra-territorial anti-bribery law, passed in the US in 1977. The act forms the basis of many anti-bribery laws around the world. It made "small, routine, non-discretionary payments to government officials" – facilitation payments – permissible by US companies. A major turning point in the fight against facilitation payments came in 2001, with the UK's Anti-Terrorism Act. It is now a criminal offence for UK companies, and UK employees of multinationals, to make such payments.

found to be either too complex or inappropriate. Companies simply aspire to meet their own standards.

The discussion then opened with a report on findings from Ipsos/MORI survey data. Although this work was not commissioned by the Woolf Committee its findings were highly pertinent. In general the data demonstrated that the globalisation phenomenon is thought to have been good for Britain by a large swathe of public opinion and within elites, although among the public there were suspicions of business leaders and practices. The larger multinational companies were expected to show corporate responsibility for consumers and for employees, though what this actually meant was vague. At the same time companies were felt to have too much influence over national economies and government decision-making, to the point where some were more powerful than governments. For this reason, both elites and the wider public opinion felt that the government should be more aggressive about regulating such companies and, more controversially, should have access to companies' private information. In Britain pressure groups were considered to make a good contribution to the nation but not corporations. Chief Executive Officers (CEOs) were often not trusted to tell the truth.

In the discussion the seminar participants were divided over facilitation payments. At one level some perceived such payments as the cost of doing business in many overseas markets. The need varies from country to country, and between customers and suppliers. Any large multinational company, however, is likely to have two or three suppliers that utilise such payments. This raised the question of how far a large multinational should or could extend its ethical framework. If such payments were inevitable then the question emerged at the operational level, when seeking to gain access to foreign markets, how to ensure that payments were appropriate rather than excessive. If there are inevitably going to be such payments how could a policy be framed to govern their use?

In engaging in international trade large multinationals will inevitably rely at times on agents or alternatively be approached by agents on behalf of suppliers. Inevitably the payments of agents are linked to their performance, which can encourage them to adopt policies at variance with those pursued by the multinational. Ensuring that

agents comply with company ethical policies can therefore be challenging. It was noted that there have been calls from some non-governmental organisations for a register to be set up or some mechanism to disclose intermediaries/agents. One option put forward was to limit bonus elements linked purely to sales volumes and incorporate an element of performance based on compliance.

Measuring and reporting ethical successes to the wider public are as important as tackling problem areas. Ethical auditing, by the Big Six accountancy firms or other qualified parties, is in the vanguard of this area. Other options include auditing/publishing rival bids in procurement competitions and public reporting of a company's ethical policies. There may be some scepticism about any initiative, such as an ethical audit, as this can look like box-ticking. In addition, publishing/auditing rival bids is a decision for government(s) and not contractors.

The potential reputational damage from a negative image was acknowledged and it was agreed that a proactive stance was needed to be taken by the boards of major companies. It was suggested that industries might consider taking the initiative and be seen to be going the extra mile. Examples were cited of the Kimberley process and the monitoring of "conflict diamonds"³. Similarly the big pharmaceutical companies have created a code of conduct for their industry and this may be appealing to other industries such as defence. There was consensus that, in terms of a company's long-term commercial interests, it made sense to tackle ethical weak-points and thus avoiding damaging reputation issues which could lead to the collapse of a share price and management sackings. This means ensuring board-driven reforms are transmitted throughout the company and to its suppliers, putting in place a supportive corporate culture that allows managers to take the initiative on ethical concerns. It was agreed that there could be a critical role and responsibility for non-executive directors in this area.

It was also recognised that government has an important role to play. For example, government and industry would need to work together when dealing with countries that encouraged corrupt practices. However, it was also recognised that different

³ 'The Kimberley Process (KP) is a joint governments, industry and civil society initiative to stem the flow of conflict diamonds – rough diamonds used by rebel movements to finance wars against legitimate governments. The trade in these illicit stones has fuelled decades of devastating conflicts in countries such as Angola, Cote d'Ivoire, the Democratic Republic of the Congo and Sierra Leone. The Kimberley Process Certification Scheme (KPCS) imposes extensive requirements on its members to enable them to certify shipments of rough diamonds as 'conflict-free'. As of September 2007, the KP has 48 members, representing 74 countries, with the European Community and its Member States counting as an individual participant,' <http://www.kimberleyprocess.com/> accessed 17 March 2008.

governments had differing expectations whilst companies were global and had to deal with a range of local customs and practice. Like the oil majors, and other multinationals, defence contractors face a situation where what is unethical – or is interpreted as unethical by local managers – in one country is considered acceptable in another. Nonetheless, the major multinationals need to conform to the highest standards in markets worldwide, even when those standards may appear excessive in a particular country/culture.

Summary of first session

To summarise this part of the discussion the following issues were raised:

- How to take a pragmatic approach to facilitation payments and agents that balances the requirements of doing business in overseas markets with the danger of corruption.
- The important role of non-executive directors in creating an ethical corporate culture.
- How to go about measuring and reporting of ethical successes to internal and external audiences.
- The need to align the approaches of government and industry in tackling problem countries/regimes.
- The creation of ethical standards by a multinational company that are followed in local markets.

Part 2 – “How should these practices be applied by Defence Contractors particularly in key areas of ethical risk for them, and the role Governments and others can play?”

This second session was introduced by a presentation of the findings of the KCL report by Professor Sir Lawrence Freedman. An edited version of these had been circulated before the meeting to the participants. This session was therefore concerned with how the generic issues related to establishing an ethical culture within a company applied specifically to defence. Is defence special and therefore does it require its own special rules?

In examining defence contractors there are immediate definitional problems - there is no universally agreed definition of what a defence contractor is. For example, if you supply the MoD with stationery are you a defence contractor or a supplier of stationery to customers including elements of government? In discussion this issue was acknowledged but could not be resolved. To a degree it was governed by the views of the company involved but it was also governed by how individual states define defence contractors and therefore there could be no uniformity here. This matter

is relevant because there is a reputation risk simply from being engaged in the defence business. Customers linked to other sectors may be influenced by a company's level of defence engagement and thus individual companies may wish to adopt definitions that exclude them from categorising themselves as defence contractors. In other words, Company Boards will occasionally have to assess whether they can afford to be branded as a defence company or not and what implications this will have.

The sector is marked by high risk, with significant consequences following success or failure in winning what are often large individual orders. There are examples in the past where the failure to win a contract has led to a company's failure or takeover. When so much is at stake there can be severe ethical challenges when companies are chasing crucial orders. Boards come under enormous pressure when a company's survival is at stake, especially when the sector is not seen to operate on a level playing field. This places significant pressure on management at all levels.

The report and subsequent discussion reaffirmed that defence exports and industry are part of public policy and there needs to be an explanation of what public policy is towards the role and conduct of the defence industry. The problem is that defence, in many ways, has a higher hurdle to jump because it is perceived to be inherently unethical (this is pertinent to the definitional point above). In Western Europe in particular the arms trade is perceived as wrong though at the same time there is an expectation that defence jobs will be preserved.

States are therefore bound to become involved in the whole process because of national security implications and therefore industry's relationship with the state is far closer than in other areas. What is the reasonable level of proximity between both parties? How should issues of loyalty and the national interest be handled? These can become acute at times of actual or potential conflict. Companies may consider themselves obligated to their own government and customer - how should they then respond? It is often the case that they have a strong presence in a number of countries, so the link between particular companies and particular states is no longer as strong as it once was. As a separate issue there are also issues of duty of care to employees when they are working alongside the armed forces in a conflict zone. This may result in differences of view with the state over the governance of these employees.

Overseas arms sales are at the heart of the moral issues surrounding the defence industry. While weapons sales to UK Armed Forces can be readily justified, this can be

much harder when it becomes sales of weapons overseas – especially to countries that are perceived of as being unstable, authoritarian, have more pressing public needs or may even potentially be future enemies. Yet national sales will not sustain defence contractors, and while alliance countries are generally unproblematic additional markets, customers will still be sought among non-NATO countries. Here it can be hard to take the moral high ground when dealing with states with practices that would be unacceptable at home and competing with other less scrupulous companies. Moreover, there is an important question of the original customer selling on products to others. Here government has an important role but the regime governing licences for the export and re-export of arms, while blacklisting certain countries, still does not fully address this issue. How far can Boards of Directors pass on these calls on to national governments? For example, in the UK controversial arms sales often take place under government-to-government agreements; they are sponsored by government, with DESO acting as the salesman for the defence contractors.

The KCL report had raised the general question of the division of responsibility in this area between the company and the state. To what extent could Boards of Directors rely upon and take direction from governments? For example, if the British government says it is appropriate to sell arms to another country is that sufficient? This debate on exports also highlighted the issue of time. Contracts could often span a decade or more whilst governments, and more importantly government policy, rarely covered such a period. The

result can be a company bound by a contract that was ethical at the time but changes in policy and societal expectations would later lead to searching questions.

To summarise this part of the discussion:

- There are major definitional problems relating to the defence sector that will not be resolved easily.
- There needs to be recognition of the close proximity of the defence industry to government and that this forms part of public policy. Governments may well be reluctant to do this and it is therefore up to the industry to start this discussion.
- Weapons sales are seen as promoting national security aims/international relations and occupy a murky space. As a result, Government has a major role to play in defining the ethical framework. It fulfils the role of law generator, judge and jury.
- Nonetheless companies will find themselves in situations where they will have a keener appreciation than government of the implications of particular sales, or how contracts are being implemented in practice, and they must be prepared to make the necessary ethical calls.
- Even when companies can demonstrate that strictly speaking their decisions have been within the law, their reputations can be adversely affected by poor ethical calls.

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April 2008

Appendix I

Bribery and corruption: The legal framework in the UK and US

Introduction

- 1 This paper introduces the most important legal regimes providing the backdrop to the Committee's work. It provides an initial overview only.
- 2 The international instruments referred to below represent obligations on signatory states such as the UK and US. It is the states' domestic legislation and not the international instruments that are enforceable in domestic courts.¹

International

*The Organisation for Economic Cooperation and Development Convention on Combating Bribery of Foreign Public Officials*²

- 3 The OECD Convention was ratified by the UK on 14 December 1998 and by the US on 8 December 1998.³
- 4 A main function of the OECD Convention is requiring each signatory to adopt the necessary national legislation to criminalise the bribery of foreign public officials. Signatories must also establish corporate liability for overseas bribery and must interpret territorial jurisdiction as widely as possible to establish both national jurisdiction and extra-territorial jurisdiction over their nationals for offences committed abroad.
- 5 Signatories must also put in place effective penalties, including seizure and confiscation or comparable monetary sanctions. They must prohibit off-the-book accounts and other accounting irregularities for the purpose of bribery or of hiding such bribery. There are also provisions on money laundering, mutual legal assistance, extradition, and monitoring.

- 6 The parties to the Convention are required by Article 12 to cooperate in carrying out 'a programme of systematic follow-up to monitor and promote the full implementation of [the] Convention'. The evaluation reports drawn up as part of this programme have identified areas of weakness in the implementing legislation and policies of the parties, and have made detailed recommendations for changes which parties have in the main heeded.⁴

United Nations Convention Against Corruption⁵

- 7 UNCAC is another instrument imposing obligations at the international legal level since it entered into force on 14 December 2005. It was ratified by the UK on 9 February 2006 and by the US on 30 October 2006.
- 8 It is not directly enforceable in the domestic legal systems of the UK or the US. However, as appears below, some of the domestic UK legislation was passed in order to promote compliance with the international obligations in UNCAC.
- 9 UNCAC is the first global anti-corruption instrument designed to fight corruption both in the public and private sectors. The purposes of the Convention are:⁶
 - a. To promote and strengthen measures to prevent and combat corruption more efficiently and effectively;
 - b. To promote, facilitate and support international cooperation and technical assistance in the prevention of and fight against corruption, including in asset recovery;
 - c. To promote integrity, accountability and proper management of public affairs and public property.

¹ See, for example, in the UK, *JH Rayner (Mincing Lane) Ltd v DTI* [1990] 2 AC 418.

² Hereafter 'the OECD Convention'.

³ In the UK, it was implemented on 14 February 2002 with the coming into force of Part 12 of the Anti-terrorism, Crime and Security Act 2001. It was implemented in the US on 10 November 1998 by the Foreign Corrupt Practices Act 1977, 15 USC 78dd-1, et seq, as amended by the International Anti-Bribery and Fair Competition Act 1998.

⁴ See, for example, 'UK: Phase 2, Report on the Application of the Convention on Combating Bribery of Foreign Public Officials' (17 March 2005), and 'UK: Phase 2, Follow-up Report on the Implementation of the Phase 2 Recommendations' (21 June 2007). For the US, see 'US: Phase 2, Report on the Application of the Convention on Combating Bribery of Foreign Public Officials' (October 2002), and see 'UK: Phase 2, Follow-up Report on the Implementation of the Phase 2 Recommendations' (1 June 2005). On enforcement, see 'Progress Report 07: Enforcement of the OECD Convention on Combating Bribery of Foreign Public Officials' (Transparency International, 18 July 2007).

⁵ Hereafter 'UNCAC'. The Criminal Justice (International Cooperation) Act 1990 (Enforcement of Overseas Forfeiture Orders) Order 2005 which came into force on 31 December 2005 and the Proceeds of Crime Act 2002 (External Requests and Orders) Order 2005 which came into effect on 1 January 2006 in order to fulfil the commitments under the UNCAC in the UK.

⁶ See UNCAC, Article 1.

10 UNCAC focuses on the following areas:

- a. The prevention of corruption both in the public and private sectors;
 - b. The criminalisation of corruption both in the public and private sectors;
 - c. International cooperation to improve cross-border law enforcement (for example, by extradition of offenders and the introduction of less formal cooperation in cross-border investigations); and
 - d. Asset recovery (signatories must establish mechanisms including civil and criminal recovery procedures, whereby assets can be traced, frozen, seized or returned).
- 11 In relation to enforcement, Article 63 provides for the establishment of a Conference of the States Parties to the Convention to be convened within one year of the Convention entering into force.⁷ A wide discretion is granted to the Conference to agree upon activities and procedures in order to establish, but only if it deems it necessary, a mechanism to assist in the effective implementation of the Convention.
- 12 UNCAC requires the provision of a cause of action against those responsible for causing damage as a result of corruption. Article 35 provides that states must ensure those suffering damage because of corruption have a right to bring legal proceedings to obtain compensation from those responsible for that damage.
- 13 It is to be noted that the UNCAC contains a large number of 'optional' Articles in the Convention. These include Articles where Parties are required simply to 'consider' adopting particular measures, as well as Articles where Parties are required to adopt measures, but only 'where appropriate and in accordance with the fundamental principles of its legal system'.

Europe

Council of Europe

- 14 The Council of Europe's⁸ definition of corruption is broader than that of the OECD, and includes both domestic and transnational corruption, private-to-private commercial corruption and influence-peddling.⁹
- 15 The Council's main initiatives against corruption include:¹⁰
- a. The '20 Guiding Principles' adopted in 1997, which define the main priorities for the fight against corruption;
 - b. The Criminal Law Convention on Corruption (1999), which aims to harmonise national laws on the definition of corruption offences and improve international cooperation, including mutual legal assistance;
 - c. The Civil Law Convention on Corruption (1999), which covers the definition of bribery, compensation for damage, liability and internal audits; and
 - d. Recommendation (2000) 10 on codes of conduct for public officials, which includes a model code of conduct.
- 16 The Council has also set up a monitoring body, the Group of States Against Corruption,¹¹ which assesses member states' compliance with the Council's anti-corruption instruments and recommends remedial actions when it identifies loopholes. GRECO sends out evaluation teams to the member states and, like its OECD counterparts, operates on the principle of peer pressure.

European Union¹²

- 17 The EU has proposed a series of measures to combat transnational corruption.¹³ Initially, the driving force seems to have been a desire to combat fraud and corruption within EU institutions.

⁷ i.e. by 14 December 2006. UNCAC came into force on 14 December 2005, 90 days after ratification by the 30th country.

⁸ At the time of writing this Report, the Council of Europe comprised 47 states from both Western and Eastern Europe.

⁹ See, for example, the Civil Law Convention on Corruption (1999), Article 2.

¹⁰ These have not been ratified by the UK.

¹¹ Hereafter, 'GRECO'.

¹² Hereafter, 'EU'.

¹³ In addition to Article 29 of the EU Treaty which refers to member states eradicating corruption as a means of achieving the objective of creating a European area of freedom, security and justice.

However, many of the same themes that occur on the wider international scene have arisen in EU discussions, including, for example, the possibility of barring offenders from future contracts. The EU has expressed its support for the OECD anti-bribery initiatives.

- 18 The main stages in EU deliberations on corruption have included the following:¹⁴
- a. July 1995: The EU adopted the Convention of the Protection of the European Communities' Financial Interests. The first and second protocols to the convention make corruption involving an EU official a criminal offence in all member states if it is damaging to the EU's financial interests. The convention and the two protocols have been signed but not yet ratified by all member states' parliaments.
 - b. December 1995: The European Parliament passed a Resolution on Combating Corruption in Europe. It calls on member states to 'abolish tax legislation and other legal provisions or rules that indirectly encourage corruption'. It also calls on the commission and member states to take precautionary measures to exclude market operators convicted of and sentenced for corruption from competing for public contracts for given periods of time.
 - c. May 1997: The EU adopted the Convention of the Fight Against Corruption Involving Officials of the European Communities. This calls for states to criminalise bribery of EU officials, whether or not EU financial interests are at stake.
 - d. In April 1999, the EU set up the European Anti-Fraud Office, an independent investigative body focusing on fraud, corruption and any other illegal activity affecting the EU's financial interests.

United Kingdom

Criminal law

19 The common law offence of bribery involves:

'...receiving or offering any undue reward by or to any person whatsoever, in a public office, in order to influence his behaviour in office, and incline him to act contrary to the known rules of honesty and integrity'.¹⁵

20 Under s.108(1) of the Anti-terrorism, Crime and Security Act 2001,¹⁶ it is immaterial for the purposes of common law bribery if the functions of the person who receives or is offered a reward have no connection with the UK or are carried out in a country or territory outside the UK.¹⁷

21 Section 1 of the Public Bodies Corrupt Practices Act 1889¹⁸ makes the bribery of any member, officer, or servant of a public body a criminal offence. In particular, the 1889 Act prohibits the corrupt giving or receiving of:

'...any gift, loan, fee, reward, or advantage whatever as an inducement to, or reward for, or otherwise on account of any member, officer, or servant of a public body ... doing or forbearing to do anything in respect of any matter or transaction whatsoever, actual or proposed, in which such public body as aforesaid is concerned'.

22 The term 'public body' includes:

'[A]ny ... body which has power to act under and for the purposes of any Act relating to local government, or ... to administer money raised by rates in pursuance of any public general Act, and includes any body which exists in a country or territory outside the UK and is equivalent to any body described above'.

¹⁴ It is to be noted that none of the following conventions are binding in the UK without being implemented by domestic legislation.

¹⁵ *Russell on Crime*, 12th ed. (London: Stevens, 1964), 381.

¹⁶ Hereafter, 'the 2001 Act'. This implemented the OECD Convention on Combating Bribery of Foreign Public Officials into English law.

¹⁷ UK law is concerned with three types of bribery, or corruption offences as they are referred to in the 2001 Act: (1) the common law offence of bribery; (2) offences under section 1 of the Public Bodies Corrupt Practices Act 1889; and (3) the first two offences under section 1(1) of the Prevention of Corruption Act 1906. For (2) and (3), see below. Section 109 of the 2001 Act provides that if a national of the UK or a body incorporated in the UK does an act outside the UK and that act would constitute a corruption offence if it were to be done in the UK, the person or the company will commit the like offence under the laws of the UK and will be subject to the jurisdiction of the courts in the UK. Section 110 is also to be noted as the presumption of corruption in s.2 of the Prevention of Corruption Act 1916 does not apply to a person or company that would not have committed a corruption offence but for section 108 or 109 of the 2001 Act.

¹⁸ Hereafter, 'the 1889 Act'.

- 23 This definition was extended by s.4 of the Prevention of Corruption Act 1916 to include 'local and public authorities of all descriptions (including authorities existing in a country or territory outside the UK)'.
- 24 Section 1 of the Prevention of Corruption Act 1906¹⁹ made bribery of or by an agent an offence. In particular, the 1906 Act prohibits an agent from obtaining and any person from giving an agent 'consideration as an inducement or reward for doing ... any act in relation to his principal's affairs'. It is immaterial whether the principal's affairs or the agent's functions have no connection with the UK or whether these functions are conducted in a country or territory outside the UK.
- 25 There are no prescribed penalties for the common law offence of bribery, but the maximum statutory penalty for bribery is imprisonment for a term not exceeding seven years and/or a fine with no upper limit.
- 26 There is no specific exemption in UK law for facilitation payments. Each payment must be judged according to whether it fulfils the criteria for the offence of bribery or corruption.
- 27 There has been pressure for an updating of the criminal provisions relating to bribery and corruption. That led to the Law Commission recommending in 1998 (in the light of the OECD Convention) the replacement of the current legislation with a single modern Corruption Act. A White Paper was published in 2000. The draft Bill eventually emerged in 2003. It attracted criticism. That led to further consultation between December 2005 and March 2006; and the Bill being dropped by the Government. There have since been attempts to introduce, as an alternative, a Bill drafted by Transparency International. This has also been blocked by the Government.
- The Proceeds of Crime Act 2002**
- 28 The Proceeds of Crime Act 2002²⁰ provides onerous requirements upon professionals to report knowledge and suspicion of the conversion of the proceeds of crime into respectable money, otherwise known as money laundering.
- 29 Under the 2002 Act, it is an offence to conceal or transfer criminal property;²¹ being concerned in an arrangement which a person knows or suspects facilitates the acquisition, retention, use or control of criminal property – a subjective test;²² and acquiring, using or having possession of criminal property. The penalty on conviction is up to 14 years' imprisonment.
- 30 It is a defence to these offences to make an 'authorised disclosure', a disclosure to the authorities in accordance with the Money Laundering Regulations 1993. Disclosures should take place before the transaction takes place unless there is a reasonable excuse not to do so beforehand but once a disclosure is made, the person making the disclosure must receive appropriate consent before completing any transaction which would amount to a prohibited act, otherwise the disclosure defence may not apply. If the person making the disclosure does not hear anything for seven days the transaction may proceed and the defence will still be available but, if it is refused, the transaction cannot safely proceed until after the 31-day moratorium period unless consent is given in the meantime.
- 31 It is also a defence to the acquisition, use and possession of criminal property offence under s.329 of the 2002 Act that a person paid a proper amount for the goods or services provided, but this does not apply if the person knew the goods and services provided might help another to commit criminal conduct.
- 32 In addition to the offences relating to criminal property, there are a number of offences dealing with failure to disclose knowledge and suspicion of money laundering offences. Section 330 of the 2002 Act imposes a requirement that any person who knows or suspects that another person is engaged in drug money laundering – who obtains that information in the course of his trade, profession, business or employment and who fails

¹⁹ Hereafter, 'the 1906 Act'.

²⁰ Hereafter, 'the 2002 Act'.

²¹ 'Criminal property' is defined in s.340(3) and (9) of the 2002 Act as property which is or represents a person's benefit from criminal conduct or which the offender knows or suspects constitutes or represents such a benefit. Criminal conduct is defined in s.340(2), (4) and (8), as conduct which would be an offence if the offence occurred in the UK. Clearly, criminal conduct includes an activity which would be a corruption offence if committed in the UK, and the profits made from any work won by such conduct would be criminal property.

²² *Ibid*, s.328.

to disclose it to the authorities as soon as reasonably practicable after it comes to the person's attention – commits an offence.²³ A similar offence exists in s.19 of the Terrorism Act 2000²⁴ in relation to offences relating to terrorist funds. The obligation imposed by this latter provision is imposed on all citizens and is not limited to those involved in business. The knowledge test in both of these offences is subjective, namely did the person have the necessary knowledge or suspicion.

- 33 The 2002 Act also contains provisions for recovery of the proceeds of crime. The Asset Recovery Agency²⁵ investigates the proceeds of criminal conduct and brings criminal confiscation proceedings.²⁶ There is also a civil recovery scheme to allow the ARA to sue in the High Court to recover property obtained through unlawful conduct.²⁷

Other legislation

- 34 A number of other recent changes in UK law targeted at crime in general could impact upon the corrupt.²⁸

Civil law

(1) Unenforceable contracts

- 35 The effect of illegality on contracts is unsurprisingly a complex area governed by principles developed over many years by the English courts. Suffice for the purpose of this Report to say any contract that is tainted with illegality, including in particular those contracts that have an illegal object, risk being unenforceable under English law.

(2) Remedies for companies with corrupt representatives

- 36 A company that can demonstrate its employee or other agent is the recipient of a bribe has a number of potential claims it can bring if the courts have jurisdiction:
- a. The recipient of a bribe holds the proceeds of the bribe on trust for his principal.²⁹ If the agent has used the proceeds of the bribe to invest in other assets, the principal will be able to assert a proprietary claim to those assets. The agent may also be liable for damages in tort.³⁰
 - b. The victim company (whose agent has been bribed) will have potential claims against the payer of the bribe in tort;³¹ for dishonest assistance in the breach of the agent's duty to his principal; and for restitution of an amount equal to the bribe.³² As a general rule, the company will only be able to recover the amount of the bribe plus any additional loss it can prove. The company will have to make an election as to which remedies it seeks.³³
 - c. Where a contract was entered into as a result of the bribe, the victim company may be able to rescind that contract.³⁴

²³ The Money Laundering Regulations 2003 extended the disclosure requirement to include the laundering of the proceeds of crime, extending the disclosures from those restricted to the laundering of drug and terrorist funds. Corruption offences are now included.

²⁴ Hereafter, 'the 2000 Act'.

²⁵ Hereafter, 'the ARA'. A written Home Office ministerial statement of 11 January 2007 proposed to merge the ARA with the Serious Organised Crime Agency but this will require primary legislation. In the meantime, ARA continues to operate as before.

²⁶ See the 2002 Act, s.1.

²⁷ *Ibid*, Part 5.

²⁸ It is noteworthy that there are a number of UK Acts that deal with specific corrupt practices, such as the Sale of Offices Act 1809, the Honours (Prevention of Abuses) Act 1925, and the Representation of the People Act 1983, ss.107, 109, and 111-115. In particular, s.577A of the Income and Corporation Taxes Act 1988 ('ICTA'), enacted under the Finance Act 1993, renders any expenditure incurred on or after 11 June 1993 'the making of which constitutes the commission of a criminal offence' not deductible in computing UK taxable profits. A conviction is not necessary to deny deductibility. Section 68 of the Finance Act 2002 further clarified the applicability of s.577A to payments that have taken place wholly outside the UK on or after 1 April 2002. Section 577 ICTA denies tax relief for any form of business entertainment, hospitality or gift. Company legislation (e.g. the Companies Acts of 1985, 1989; the Insolvency Act 1986; the Enterprise Act 2002; the Companies (Audit, Investigations and Community Enterprise) Act 2004; and the Companies Act 2006 (accounting provisions which came into force in April 2008) require every company to keep accurate accounting records. False or fraudulent accounting is an offence under the Theft Act 1968.

²⁹ See *Attorney-General for Hong Kong v Reid* [1994] 1 AC 324.

³⁰ See *Fyffes Group Ltd v Templeman*, *The Times*, 14 June 2000.

³¹ See *Mahesan v Malaysia Government Officers' Co-operative Housing Society Ltd* [1979] AC 374.

³² *Ibid*.

³³ *Ibid*.

³⁴ See *Logic Rose v Southend United FC* [1988] 1 WLR 1256.

United States

General law on bribery and corruption

37 Under US law, foreign and domestic bribery falls under several distinct federal and individual state criminal statutes. Generally, the prohibited conduct involves paying, attempting or promising to pay, US or non-US government officials improperly to influence their official acts, or, in the private context, causing an employee or agent of a company to act in a way contrary to the interests of their employer. US federal laws prohibit bribery of both domestic US and non-US government officials. In addition, individual state laws make it a crime to bribe domestic state and local officials. State commercial bribery statutes also make it a crime to bribe employees of private businesses and for employees to accept a bribe. Further, US law generally recognises the concept of aiding and abetting a violation and conspiring to engage in violative conduct as separate criminal offences.

US Federal law on bribery and corruption

38 US federal law prohibits bribery of both non-US and domestic federal public officials. The US federal anti-foreign bribery statute is the Foreign Corrupt Practices Act 1977, as amended.³⁵ The FCPA applies to US persons and companies, any stockholder, officer, director, employee, or agent acting on behalf of a US company, and to any company that has a class of securities registered pursuant to Section 12 of the Securities Exchange Act of 1934³⁶ or that is required to file reports with the Securities and Exchange Commission³⁷ pursuant to Section 15(d) of the Exchange Act.³⁸ Any UK company with US-listed securities (as well as its officers, directors, employees and agents), wherever they are located, therefore, can be subject to the FCPA.

39 The FCPA can also apply to any non-US company or individual if prohibited acts are taken within the United States. This has been broadly interpreted to apply to any act that occurs within, or is directed within, US territory, including for example, an email sent into the US or a wire transfer through a US bank that broadly can be seen as an act in furtherance of the prohibited conduct.

40 The FCPA has two separate sets of provisions, the anti-bribery provisions and the books and records

provisions, discussed briefly below, and carries both civil and criminal penalties. The US Department of Justice and SEC each have jurisdiction to enforce the FCPA, and companies often face independent actions by both authorities.

41 As a general matter, the FCPA anti-bribery provisions make it illegal under US law for subject companies and individuals: (i) to utilize the 'instrumentalities of US commerce' – such as the mails, phone lines, or internet or to take any act while within the United States; (ii) in furtherance of a payment or an offer, promise, or an authorisation to make a payment, or to provide anything of value, directly or indirectly; (iii) to a non-US government official, political party or candidate; (iv) to influence his or her official actions or to induce such official to use his or her influence; (v) in order to assist the company to obtain or retain business, to direct business to any person or to secure an improper advantage. The FCPA further prohibits knowingly engaging in the prohibited conduct through a third party, such as a consultant, contractor, joint venture partner or other business associate.

42 The FCPA prohibits indirect as well as direct improper payments. In this regard, the FCPA expressly applies to actions taken through 'any person, while *knowing* that all or a portion of such money or thing of value will be offered, given, or promised, directly or indirectly', to any government official for a prohibited purpose. A person is deemed to have knowledge under the FCPA if he or she is aware of a 'high probability' that the conduct had occurred or would occur. A person's 'conscious disregard', 'willful blindness', or 'deliberate ignorance', of culpable conduct or suspicious circumstances may be adequate to support a violation of the FCPA.

43 The definition of 'government official' under the FCPA is broad and includes an individual who (i) is an employee, officer, or representative of any civilian or military government agency, instrumentality of a government agency, government-controlled commercial enterprise, or public international organisation; (ii) has an office or position in a political party; (iii) is a candidate for political office; or (iv) otherwise holds any royal

³⁵ Hereafter, 'FCPA'. 15 U.S.C. § 78dd-1, et seq., as amended. It is noteworthy that in recent years there has been an increase in enforcement activity by the US authorities.

³⁶ Hereafter, 'Exchange Act'.

³⁷ Hereafter, 'SEC'.

³⁸ Hereafter, 'US issuer'.

family, official, ceremonial, or other positions with a government or any of its agencies.

- 44 The books and records provisions of the FCPA require US issuers to ensure: (i) that books, records and accounts are kept in reasonable detail to accurately and fairly reflect transactions and dispositions of assets, and (ii) that a system of internal accounting controls is devised in order to: (a) provide reasonable assurances that transactions are executed in accordance with management's authorisation; (b) ensure that assets are recorded as necessary to permit preparation of financial statements and to maintain accountability for assets; (c) limit access to assets to management's authorisation; and (d) make certain that recorded accountability for assets is compared with the existing assets at reasonable intervals and appropriate action is taken with respect to any differences.
- 45 Under the books and records provisions, US issuers are held responsible for ensuring that their majority-owned or controlled subsidiaries, both US and non-US, comply with the requirements. In addition, the FCPA requires that a US issuer make a good faith effort to ensure that any company (including joint ventures) in which the US issuer or one of its subsidiaries holds fifty per cent or less of the voting power comply with the books and records provisions. No materiality standard exists under the FCPA and, therefore, there is no de minimis exception to the books and records requirements.
- 46 In contrast to the UK, the FCPA has an express exception for facilitation or expediting payments to a foreign official, political party, or party official. These are relatively insignificant payments made to facilitate or expedite performance of a 'routine governmental action'. Routine governmental actions do not include 'any decision by a foreign official whether, or on what terms, to award new business to or to continue business with a particular party, or any action taken by a foreign official involved in the decision making process to encourage a decision to award new business to or continue business with a particular party'.³⁹ US authorities have interpreted this exception very narrowly.
- 47 The FCPA also provides for two affirmative defences for certain payments. The first affirmative defence under the FCPA is for 'the payment, gift, offer, or

promise of anything of value that was ... lawful under the written laws and regulations' of the non-US country in which it was made. This defence has been interpreted narrowly to include only express written laws permitting such payments. The second affirmative defence is for 'the payment, gift, offer, or promise of anything of value that was [a] ... reasonable and bona fide expenditure, such as travel and lodging expenses' and was directly related to the promotion, demonstration, or explanation of products or services, or the execution or performance of a contract with a non-US government or agency thereof.

- 48 The US Department of Justice in public statements and in departmental memoranda has indicated that an effective compliance program is a mitigating factor in its consideration of whether to bring charges against a corporation and in its negotiation of plea agreements. In this regard, the US Department of Justice has indicated in recent enforcement actions that, in general, an effective compliance program should include the following elements:
- a. A clearly articulated corporate policy against violations of the FCPA and other applicable anti-bribery laws;
 - b. The designation of senior official(s) with oversight responsibility;
 - c. The establishment of a committee to review third-party relationships;
 - d. Due diligence procedures;
 - e. A training program;
 - f. Disciplinary procedures regarding violations of the compliance program;
 - g. Procedures to report suspected improper conduct, including an anonymous 'hotline';
 - h. Contract language in consultancy, joint venture and other agreements with business associates that proscribe improper payments;
 - i. The maintenance of books and records and establishment of a system of internal accounting controls; and
 - j. The periodic internal audit of the program.

³⁹ FCPA, s.78dd-1(f)(3)(B) and s.78dd-2(h)(4)(B).

The US Department of Justice also has indicated that in order to be effective, compliance programs need to be tailored to the specific business of the company and enforced by the company.

- 49 The penalties for violations of the FCPA's anti-bribery and corruption provisions are severe. For criminal convictions, companies could be fined the greater of \$2 million for each violation or twice the gain earned on any business obtained through conduct that violated the FCPA. In addition to similar criminal fines, individuals can be imprisoned for up to five years. For civil violations, penalties of \$10,000 for each violation may be imposed both on companies and individuals. Moreover, in recent years, SEC⁴⁰ has insisted that companies disgorge all profits earned through conduct that violated the FCPA.⁴¹ In several recent cases, the US Department of Justice and SEC have also required companies to engage for a three year period an independent compliance monitor that provides periodic reports to the US authorities.
- 50 Several other US federal criminal statutes often come into play in connection with criminal corruption investigations. These statutes include the Travel Act,⁴² federal mail and wire fraud statutes,⁴³ and the Money Laundering Control Act 1986,⁴⁴ to name a few. For example, the Travel Act makes it a crime to travel in interstate commerce or use the mail or any interstate facility with the intent to commit bribery under the law of the state in which the act was committed. The US Money Laundering Control Act generally makes it a crime to conduct or to attempt to conduct a financial transaction from or through the US, while knowing that the funds at issue involve the proceeds of illegal activity, such as a violation of the FCPA, or are intended to be used for illegal activity or if the transaction is intended to conceal illegal activity.
- 51 On 5 October 2000, the US passed the International Anti-Corruption and Good Governance Act 2000⁴⁵ for '... the promotion of

good governance through combating corruption and improving transparency and accountability' through foreign governments. This Act, among other things, authorises the US President to establish programs that combat corruption, improve transparency and accountability, and promote other forms of good governance in developing countries. The US, under the FCPA, was the first UN member state to criminalise international bribery and it recognises that many developing countries lack the ability to fend off corruption alone.

- 52 The US federal laws also include various domestic bribery statutes, including 18 USC s. 201, which prohibits bribery of US domestic 'public officials', which include, for instance, Members of Congress, and US government employees. This statute prohibits the giving of anything of value to a public official or person who has been selected to be a public official, corruptly in order to: (i) influence any official act; (ii) influence such public official or person who has been selected to be a public official to commit or aid in committing or collude in, or allow, any fraud or make opportunity for the commission of any fraud on the United States; or (iii) to induce such public official to do or omit to do any act in violation of the lawful duty of such official or person. 18 USC s. 201 also criminalises the receipt of such payments by US domestic federal public officials.

Private causes of action for bribery and corruption

- 53 There are a variety of private causes of action that may flow from facts establishing a violation of the federal and state anti-bribery laws. Of most significance, facts that support conduct in violation of the anti-bribery provisions of the FCPA may also give rise to a private cause of action for damages under the US Federal Racketeer Influenced and Corrupt Organizations Act.⁴⁶ RICO, a complex statute originally designed to address criminal racketeering activity, provides a private right of action for treble damages.

⁴⁰ The SEC has civil enforcement authority in matters involving public companies, while the US Department of Justice prosecutes criminal cases. Factors that might influence government authorities in exercising their discretion to take action against a company include blatant wilfulness, actors at the highest level of the company, falsification of records, or a determination that there has been perjury or obstruction in the course of an investigation. Other indicators, for example recidivism or lack of internal controls, might also influence the penalty sought by civil and criminal authorities.

⁴¹ Consequently, companies have paid millions of US dollars to resolve FCPA investigations.

⁴² 18 U.S.C. § 1952.

⁴³ *Ibid.*, §§ 1341 and 1343.

⁴⁴ *Ibid.*, § 1956, et. seq.

⁴⁵ Public Law 106-309.

⁴⁶ Hereafter, 'RICO'. 18 U.S.C. §§ 1967-68.

US State law on bribery and corruption

- 54 In addition to the federal anti-bribery laws, US states individually have their own set of statutes that address both public bribery and commercial bribery in connection with private (non-governmental) business.
- 55 Individual state statutes, which vary from state to state, prohibit the bribery of state and local officials. For example, New York law prohibits, among other things, conferring or offering or agreeing to confer any benefit upon a public servant under an agreement or understanding that such public servant's vote, opinion, judgment, action, decision or exercise of discretion as a public servant will thereby be influenced.⁴⁷ New York law also criminalises the receipt of such payments by public servants.⁴⁸ Similarly, California law prohibits individuals from offering a bribe to, among others, executive officers, 'with the intent to influence him in respect to any act, decision, vote, opinion, or other proceeding as such officer'.⁴⁹ California law also prohibits an executive official from receiving such a payment.⁵⁰
- 56 State commercial bribery statutes, which vary to some extent from state to state, generally make it a crime to bribe employees of private businesses or for an employee to accept a bribe. For example, New York State law on commercial bribery prohibits an individual from conferring a benefit upon an agent or fiduciary without the consent of the latter's principal, with the intent to influence his conduct in relation to his principal's affairs.⁵¹ An employee, agent or fiduciary is also guilty of commercial bribery for receiving such a benefit.⁵² California law provides that any employee who accepts money or anything of value from another person other than his employer, other than in trust for the employer, corruptly and without the knowledge or consent of the employer, in return for using or agreeing to use his position for the benefit of that other person, and any person who offers or gives an employee money or anything of value under those circumstances, has committed an offence.⁵³

⁴⁷ New York Penal Law § 200.00.

⁴⁸ Ibid, §§ 200.25 and 200.27.

⁴⁹ California Penal Code § 67. California law also prohibits such payments to Members of the Legislature under § 85.

⁵⁰ Ibid, § 67.5.

⁵¹ New York Penal Law § 180.00.

⁵² Ibid, § 180.05.

⁵³ California Penal Code § 641.3.

Appendix J

Advisers

Definition of advisers	
<ul style="list-style-type: none"> ● The term 'Advisers' includes all advisers, agents, sales representatives, consultants and brokers that facilitate transactions relating to defence industry equipment and services between suppliers and recipients. ● The specific activities performed by an Adviser may include the following: <ul style="list-style-type: none"> – introduction of the supplier and recipient – lobbying to obtain the contract – conducting the bidding process – financing of the sale – assisting in the negotiation of side-agreements – procuring the arms and/or negotiating the logistics of arms deliveries 	
Selection	
Need for an Adviser	<ul style="list-style-type: none"> ● A senior executive of the company (e.g. relevant Managing Director or Marketing/Sales Director) should endorse whether there is a need to appoint an independent Adviser for a given market, product or service. ● The endorsement of the bona fide business reasons and/or legal need to appoint an Adviser should be documented.
Identification of candidates	<ul style="list-style-type: none"> ● A senior executive of the company should be responsible for proposing an Adviser. ● The Operating Group/Chief Counsel should be expected to conduct low level due diligence on all proposed Advisers. ● Application forms should then be sent out.
Application forms	<ul style="list-style-type: none"> ● Standard application forms should be sent out and completed in writing by candidates, eliciting information that includes: <ul style="list-style-type: none"> – the nature and history of the applicant's business – the ownership and principal officers and managers of his firm – his representation of other companies – his office facilities and staff – affiliated companies – business or personal relationships with the proposed customer – principal product lines currently handled for other enterprises – any litigation involving his activities – market information – financial statements (2 years) – 3 financial references (bank, commercial, embassy and consular) with an assessment of the Adviser's commitment to the company's anti-corruption policy and the necessity of complying with it – references should be accompanied by an authorisation for the release of information from the references the candidate has provided

<p>Due diligence</p>	<ul style="list-style-type: none"> ● Internal due diligence should be conducted by a central unit in a company (reporting to the company's Chief Legal Counsel) on a proposed Adviser and his sub-contractors. This should be supplemented with appropriate external due diligence. ● The due diligence should verify and document as far as possible on the Adviser's experience and references, government affiliations, corporate structure and financial status, to ensure the Adviser: <ul style="list-style-type: none"> – conducts a legitimate business – complies with accepted business practice standards – commands the technical skills required for the performance of the contractual services – is of good standing in the business community – has no history of inappropriate relationships with potential customers – has no conflicts of interest or, where conflicts of interest do exist, they are addressed – is highly regarded by embassy and any other appraisals ● The company should retain all due diligence records for a minimum of five years after termination of the contract in case allegations of illegal practices are raised.
<p>Red flags or "warning signs"</p>	<ul style="list-style-type: none"> ● The raising of any of the following with regard to an Adviser may indicate the need for enhanced due diligence or in some cases should result in the immediate termination of the relationship with the Adviser: <ul style="list-style-type: none"> – a history of corruption in the territory – lack of experience in the sector or the country in question – non-residence in the country where the customer or the project is located – no significant business presence within the country – represents companies with a questionable reputation – refusal to sign an agreement to the effect that he has not and will not make a prohibited payment – states that money is needed to "get the business" – requests "urgent" payments or unusually high commissions – requests payments be paid in cash, use a corporate vehicle such as equity, or be paid in a third country, to a numbered bank account, or to some other person or entity – requires payment of the commission, or a significant proportion thereof, before or immediately upon award of the contract by the customer to the company – claims that he can help secure the contract because he knows all the right people – has a close personal/professional relationship to the government or customers that could improperly influence the customer's decision – is recommended by a government official or customer – arrives on the scene just before the contract is to be awarded – shows signs that could later be viewed as suggesting he might make inappropriate payments, such as indications that a payment will be set aside for a government official when made to him – insufficient bona fide business reasons for retaining an Adviser
<p>Interview</p>	<ul style="list-style-type: none"> ● There should be a face-to-face interview (attended by a senior lawyer from the company) during which the company's anti-bribery policies are clearly communicated and the applicant's responses assessed.

<p>Committee Review</p>	<ul style="list-style-type: none"> ● Companies should have their own centralised approval process of any proposal to appoint an Adviser combined by a senior lawyer of the company, and ideally a committee of experts (outside of the business or marketing function) who can review and advise the company's Board of Directors (in accordance with specific guidance terms provided by the company) on all applications for appointment or re-appointment of Advisers. ● The committee should only consider recommending to their company's Board that a proposed appointment will comply with the company's policies and procedures where all of the following are demonstrated without any material doubt by the applicant: <ul style="list-style-type: none"> – a documented business case for appointing an Adviser in a specific market for a particular product – a justification for the amount and structure of payment proposed (see Payment size, below) – there is no apparent risk of corruption of any kind – no reputational or other harm would be caused to the company if the Adviser were retained and its mission and the terms of its engagement were disclosed publicly ● The outcome of the review should be either: <ul style="list-style-type: none"> – to consider appointment of an Adviser – that further information is required for it to make an assessment – to not appoint an Adviser
<p>Appointment</p>	
<p>Contract</p>	<ul style="list-style-type: none"> ● There should be a signed contract between an Adviser and company before that Adviser carries out any work for the company. It should be standardised and for a fixed term of no more than 2 years. ● The contract should be subject to the opinion of legal counsel acknowledging that local law permits the relationship or transaction in question. ● The contract should contain provisions that, at a minimum: <ul style="list-style-type: none"> – acknowledge the Adviser's adherence to the relevant anti-bribery laws and the company's anti-bribery policies – describe in clear terms the work/services to be provided – oblige the Adviser to maintain accurate, complete and transparent accounting – permit the company to terminate the relationship if the Adviser breaches any covenants, or if a change in circumstances enhances the likelihood of a violation – oblige the Adviser to indemnify the company for any and all damages arising from the Adviser's breach – all payments will be made directly to the Adviser; cash payments or payments to a third party will not occur – provide that no rights or obligations of the Adviser may be assigned or delegated to a third party – provide that the company reserves the right to perform random compliance audits of Advisers – travel and entertainment expenses will be paid only after company approval and through documentation – provide that no modifications to the standard form should be permitted without the approval of appropriate senior management or the legal department – provide that any proposed variation to the terms of the contract will require additional due diligence

	<ul style="list-style-type: none"> – explicitly prohibit illegal payments – provide that Advisers must supply companies with quarterly activity reports, in a standard form, for each service they agree to perform – provide that companies should at their discretion be entitled to disclose to the customer the identity and payments of and products and services provided by an Adviser ● Companies should also oblige Advisers to sign an agreement that in the event the company is investigated in respect of bribe payments, the Adviser will cooperate with such an investigation even after the expiration of their contract to perform the work or service.
<p>Payment size</p>	<ul style="list-style-type: none"> ● Payments must be standardised, adequate in relation to legitimate services rendered, and must take account, at a minimum, of the following (see Committee Review above): <ul style="list-style-type: none"> – reasonable proportionality between (i) the main contract’s value in relation to the Adviser’s contract, (ii) working time taken by Adviser to secure the main contract, and (iii) working expenses – provision for the commission percentage to decline as the main contract’s total value increases – the Adviser’s specific competence, expertise and resources – the complexity of activities or transactions involved – the Adviser’s past performance – payment for the nature and duration of contacts with the customers – adjustment as appropriate according to a comparison with rates for such services in the market served – any proposal for variation in payment size from that reviewed by the Committee Review should be subject to the Committee’s approval
<p>Payment method</p>	<ul style="list-style-type: none"> ● All payments should be made directly to the Adviser; payments in cash, use of a corporate vehicle such as equity, payments to a third party, a numbered bank account, or to some other person or entity, should not occur. ● Travel and entertainment expenses should be paid only after company approval and against receipts or other appropriate documentation. ● Accurate records should be kept, showing details of all payments; there should be annual reviews of all payments.
<p>Management</p>	
	<ul style="list-style-type: none"> ● Companies should have procedures that are periodically tested to enable the monitoring of Advisers and assessments of whether their contracts have been fulfilled in conformity with the laws and company policies.
<p>Accountability of Advisers</p>	<ul style="list-style-type: none"> ● Advisers should be contractually required to submit to companies quarterly activity reports in a standard form for each service they agree to perform. The reports should be subject to regular internal audit and all payments should be suspended if an Adviser does not submit activity reports in accordance with their agreement. ● Each Adviser should be assigned a Principal Contact at the company who will monitor the accuracy of each Adviser activity report and continuously assess the Adviser’s performance and conduct. This should include responsibility for raising and monitoring possible red flag issues. ● There should be an obligation on Advisers to notify changes to their directors, officers, employees or consultants, to enable companies to conduct due diligence on such people immediately.

Repeat due diligence	<ul style="list-style-type: none"> ● Companies should specify a demanding frequency of repeat due diligence with repeat interviews where necessary, for example at least every two years. They should conduct periodic reviews of all payments across the company to Advisers. The overall record of such payments should be disclosed to the audit committee. ● The company should retain all due diligence records for a minimum of five years after termination of the contract in case allegations of illegal practices are raised.
On-going training	<ul style="list-style-type: none"> ● Companies should, at least on an annual basis, train all Advisers on their anti-bribery compliance obligations, including a summary of relevant host nation, other jurisdictional anti-bribery laws and regulations and international treaties and conventions. ● Training activities should be assessed periodically to maximise effectiveness.
Breach of contract and termination	<ul style="list-style-type: none"> ● Companies should: <ul style="list-style-type: none"> – suspend all payments to an Adviser if the Adviser does not comply with his agreement. – terminate the Adviser's contract upon breach of any covenant or increased probability of violation because of a change in circumstances – oblige the Adviser to indemnify the company for any and all damages arising from the Adviser's breach, including recovery of payments paid to the Adviser
Audit and assurance	
Record keeping	<ul style="list-style-type: none"> ● There should be regular internal and external audits of compliance with company policies and procedures. ● Accurate records relating to Advisers should be kept documenting: <ul style="list-style-type: none"> – all due diligence – showing whether all services have been duly and properly rendered – receipts of deliverables – showing details of all payments; there should be annual reviews of all payments – all training undertaken and completed – Companies should retain these records for a minimum of five years after termination of the contract in case allegations of illegal practices are raised

Sources

The above table was compiled having consulted a number of authorities and included the following:

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