Compliance Connect

The three-plus-one riddle: Managing third party and related risks

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Editor's desk

In this edition, we walk you through the risks emanating from third and fourth parties and share some of the best practices to effectively manage these risks

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Dear Readers,

We are happy to bring you the next edition of Compliance Connect, our periodic newsletter focused on providing insights and expert opinion in the compliance domain.

The universe of risks emanating from third and fourth party is extensive and implications of risk oversight, severe. Appropriate third-party due diligence and compliance, needless to say, must be high on organisations' agenda. Greater value from a third-party risk management programme can be effectively derived when it is tailored to the unique requirements and risk appetite of the organisation. In this edition, we help you simplify the 'three-plus-one riddle', taking you through the spectrum of risks imposed by third and fourth parties and strategies to mitigate these risks effectively.

While it is our endeavour to assist you in fulfilling your vision towards being compliant, we always look forward to engaging better with you. Do share your valuable feedback. In case you want us to address any specific area in compliance, feel free to write to us.

We hope you find the information in this newsletter useful.

Experts speak

Companies may outsource their activities, but not their responsibility to manage and mitigate risk.

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Background

While third-party risks pose serious ramifications, non-compliance risks from "vendors' vendor" further compound vulnerabilities. Existing due diligence programmes may not suffice if they do not consider the spectrum of third-party risk or reassess due diligence in the prism of increased global risks of third parties and their counterparties.

This is particularly true for high-risk geographies where bribery and corruption are rampant. Further, the challenge to 'effectively' manage these risks is a formidable one, given the sheer scale of vendors, suppliers, agents, etc of any organisation and their subsequent magnitude of business transactions involved. The answer lies in a structured, documented and agile approach to mitigate these risks.

Why manage this risk on high priority?

The answer is simple: because the perils of not doing so are serious.

- **Managing third-party and counterparty risks is your responsibility:** Companies may outsource their activities but not their responsibility to manage and mitigate risk. Regulatory authorities would hold the firm responsible not only for its own actions, but also for the unlawful actions of its vendors, suppliers, agents, service providers, etc.
- **Rising fraud risks in supply chain:** Increasingly complex supply chains involve multiple layers of vendors and their sub-contractors, resulting in higher vulnerabilities of fraud and misconduct. When an organisation is not aware of these sub-contractors in the first place, they fail to appear in its risk perimeter. However the organisation will have to face the outcome of their neglect, which could be a sub-standard product or service, labour abuse or a mishap from inadequate safety measures in a factory.
- **Heightened regulatory focus and global anti-corruption requirements:** Globally, anti-corruption programmes lay emphasis on how third parties are engaged and monitored on an ongoing basis. Enforcement actions by regulators like the Securities and Exchange Commission (SEC) and Department of Justice (DOJ) have been a reminder of companies having to pay a high price of illicit conduct of their third parties. Especially in the case of multinational organisations, if agents engage in corrupt practices to win a contract or obtain a permit, it exposes the company to a significant liability. Kickbacks, facilitation payments, violation of gifting and entertainment policy, among others, can result in massive regulatory fines and a blemished reputation for the organisation.

Key risks

- **Compliance risk:** Organisations need to comply with existing laws of the region where the intermediaries operate. They also need to comply with the provisions of global anti-corruption regulations like the Foreign Corrupt Practices Act (FCPA) and the UK Bribery Act. This is particularly a concern in countries which rank high on corruption and within functions involving routine dealing with public officials. Other risks pertain to conflict of interest or non-compliance with the organisation's code of conduct, policies or procedures.
- **Reputation risk:** Organisations with a global presence have an expansive network of third-party entities, spread across territories. One weak link in this web can put the organisation in bad light. This could be triggered by an act of fraud or corruption, illicit trade, inferior product, data theft, etc.
- **Information risk:** Increased risk of third-party breaches is high given the digital world businesses operate in. Incidents of compromised data caused by third parties or sub-contractors can result in lost revenues, reputation, productivity and, most of all, information. When any part of the IT operation is outsourced, it exposes a vulnerability in data security
- **Financial risk:** Financial risks pertain to overbilling, siphoning of funds, inflated costs and cargo theft, resulting in substantial cash leakages for the organisation.
- **Operational risk:** A potential system outage at a sub-contractor may result in loss of hundreds of dollars for the organisation. Similarly, pilferage of goods, systems failure or inadequate internal processes have the capability to disrupt business functions and can cost the organisation dearly.

Mitigate with a risk-based approach

Some of the areas that can be considered to mitigate the risks associated with third-party intermediaries and counterparties include:

- **Know the universe of your third parties:** Before addressing the risks associated with a third party, the first step is to know who you are dealing with. With the sheer number of third-party relationships and their sub-contractors, these networks can be a challenge to identify but can be combated with a structured approach. A typical organisation engages with hundreds of agents, vendors, suppliers, resellers etc.

The objective of reasonably simplifying this universe can be fulfilled by:

  - maintaining a central repository of third-party relationships
  - establishing a robust framework to categorise the entire ecosystem into high, medium and low risk category
  - aligning the approaches in your risk management to effectively mitigate, detect and prevent the above identified relationships against the risk appetite of your organisation
  - including the entities of key suppliers or service providers of your third-party in this risk assessment

- **Conduct comprehensive and 'ongoing' due-diligence:** Comprehensive due diligence is the cornerstone to managing third-party risk. Appropriate due diligence in selecting a third-party involves, among others, reviewing their business history, reputation, use of subcontractors, scope of internal controls etc. However, the process of mitigating risk must not end here. Third parties need to be regularly monitored as a part of ongoing compliance with measures like conducting surprise site visits and reviewing contract compliance.

- **Effective contract risk management:** Once a third-party is on board, effective contract management is critical as a contract defines the organisation's relationship with the third party. While the strategies in effective contract management are an expansive subject in themselves, clearly drafted clauses, standard templates and annual review of contracts must be taken into account while managing contracts. The process of managing contractual risks can be simplified by deploying an effective technology management solution.

- **Allocate resources:** Managing risks of third-party and related entities requires appropriate investment in due diligence, third-party accreditations, provision for training on company's code of conduct and ethics policy, anti-bribery training etc. It must be considered as a valuable investment, and not a cost.

- **Adopt a technology-driven approach:** Gaining visibility into data of multiple third parties can be intimidating. Use of advanced technology, automation and data analytics to consolidate the otherwise unstructured data of third-parties can help make informed decisions and dramatically reduce the effort involved. Standardised processes pave way to derive greater value from the data. They also simplify the process of periodic performance review of third-party relationships.

- **Executive oversight:** Given the ability of one weak link in these relationships to affect business continuity and cause regulatory, monetary and reputational fallouts, board oversight in this area should be heightened. The board must get visibility into the 'key' vendors and the risks faced by the organisation's third-parties and counterparties, and then conduct periodic reviews of existing governance framework to mitigate these risks. Gathering insights into the allocated resources, technology deployed and pragmatic lessons from past incidents is a suitable step in this direction.

Food for thought: Third-party risk ownership

The question on the accountability of risks posed by the universe of third parties and associated providers is a critical one.

Though the degree of surveillance exercised or concentration of efforts to mitigate risks by the concerned functions or roles may vary, the ultimate responsibility resides with the management, the board, compliance function and, in fact, the entire fabric of the organisation, and not with a single function or role.

In a technology firm, for instance, the IT function may be actively involved in overseeing and implementing the risks posed by the outsourced activity. Similarly, the role of Chief Procurement Officer becomes critical during the process of bidding for contracts. However, third-party oversight cannot be conducted in silos, and collaboration between different functions and appropriate guidance from the top are vital. Risks resulting from third parties have an enterprise-wide impact and, therefore, their mitigation also needs to be a top-down effort.

Conclusion

While fraud risks from third parties and their counterparties have flourished, these can be significantly curtailed with appropriate due diligence, adequate controls, oversight and monitoring. Greater value from a third-party risk management programme can be derived if its tailored to the unique requirements and risk appetite of the organisation. The key is to track the progress once a solid foundation has been laid.

News Snippets

DOJ rolls out new policy against 'piling on'	SEBI tightens rules on corporate governance	MACC Bill makes firms liable for graft
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