

Avoiding trouble IN CHINA

How to stay on the right side
of international anti-bribery laws

BY PETER HUMPHREY, CFE

In the last three decades, China has shown stunning economic and social progress. However, its super achievements have come at a cost — the dramatic resurgence of corruption and widespread fraud. Here are ways that multinational companies can keep out of trouble in China.

UTStarcom, a U.S.-listed firm with Chinese roots, paid US\$7 million for hundreds of overseas trips by the personnel of Chinese state-owned enterprise (SOE) telecom firms for so-called “customer training.” Actually, the trips were sightseeing jaunts to flashy tourist and gambling spots including Las Vegas, Hawaii and New York.

How does this kind of racket work? Executives of major SOEs typically demand “product inspection” trips financed

by U.S. manufacturers with a budget of US\$4,000 to US\$6,500 per person for spending 14 days in the U.S., Europe or Australia.

A typical itinerary includes New York, Las Vegas, Los Angeles and Hawaii, or trips to Australian cities with a Thailand leg, or with Rome, Madrid and Copenhagen thrown in.

The parties discuss such provisions with the manufacturer’s Chinese SOE distributor, but the official contract doesn’t

include the production inspection trips’ budget, except perhaps for a vague mention of “buyer’s rights to inspect goods.”

“Visit fees,” however, appear in a manufacturer’s sales order for internal accounting. The manufacturer wires the funds in cash to a personal account or the overseas accounts of the distributors. Part is paid to domestic or foreign travel agents, and part is paid in cash to the traveling SOE executives. Sometimes distributors wire funds to overseas accounts.



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Money from more than one foreign manufacturer may sometimes be pooled into a slush fund to finance a combined touring delegation.

If the Chinese SOEs don't visit, the U.S. manufacturer can't return unspent funds to the company account because if it does, then the SOE executives will be caught. (See "Telecom Company to Pay \$3 Million in China Bribe Case," by David Barboza, Jan. 1, 2010, <http://tinyurl.com/858fho9> and "SEC charges California telecom company with bribery and other FCPA violations," Dec. 31, 2009, <http://tinyurl.com/y98y5dp>.)

This is one of scores of new corruption cases resulting from China's changing cultural and economic climates.

I have spent most of the past 30 years or so in China — with the last 14 working in fraud and corruption investigations. When I look at the country today and think about the nation when

I arrived in 1979 — a country driven by horse carts and mired in deep poverty — it's impossible to ignore its stunning progress. Yet, China's super economic achievements have come at a cost — the dramatic resurgence of corruption and widespread fraud. This plague is challenging multinational companies who risk running afoul of international anti-bribery laws over malpractices in China.

First let's take a quick look at the economic and social environment that has spawned this corruption.

By certain benchmarks, China has now become the world's second-largest economy after the U.S. While much of the world was in a deep recession, China surged ahead, continuing to report stunning annual GDP growth rates of about 10 percent. China's GDP in 2011 reached US\$7.49 trillion, according to the National Bureau of Statistics of China (<http://tinyurl.com/7pt5zfb>). Foreign direct investment in China in 2011 reached US\$117.7

billion, according to China's Ministry of Commerce (<http://tinyurl.com/7t359m3>).

Against China's amazing economic backdrop, the country has the world's largest population — 1.3 billion plus and still growing. Half this population still lives off the land, with income levels much lower than the wealth of the coastal cities and the urban elites. One of the largest drivers of graft and fraud in China is this economic polarization of rich and poor and the pressure to make money by every imaginable shortcut. Let's look at a few illustrations of this wealth gap.

Despite China being the world's second largest economy, its per capita GDP is a mere fraction of America's. Mainland China's in 2011 was US\$5,555, according to the National Bureau of Statistics of China compared with about US\$48,387 in the U.S., according to the World Economic Outlook Database of the International Monetary Fund (<http://tinyurl.com/6omo7ap>). We see data like

China's retail sales growing 17.1 percent in 2011 while the rest of the world is in recession. But urban per capita disposable income in 2011 stood at a paltry annual level of US\$3,461.9, according to the National Bureau of Statistics of China (<http://tinyurl.com/7pt5zfb>).

In the countryside, where half the population lives, rural per capita income in 2011 was just US\$1,107 per year, according to the National Bureau of Statistics of China (<http://tinyurl.com/7pt5zfb>). We see lots of stories about Chinese millionaires, but the figures above mean that half the Chinese population lives on little more than \$2 per day. The wealth gap is a major contributing factor to bribery in this country.

And then there's the issue of ethics. China is still burdened with the legacy of the Cultural Revolution, a radical Maoist political upheaval in the 1960s and 1970s that trashed all traditional virtues, religions and philosophies and closed down all the schools and vilified all the teachers. The aftermath of that revolution was a moral vacuum. People no longer knew what to teach their children, and a free-for-all unfolded in Chinese society when their new leader Deng Xiaoping egged them on with slogans such as "To get rich is glorious" and "It doesn't matter whether a cat is black or white, so long as it catches mice."

In recent years, there have been some high-profile crackdowns. Although corruption still exists at all levels, some recent cases have served as harsh warnings for those involved in such behavior. One of the harshest of all was the execution of the head of China's Food and Drug Administration for large-scale corruption.

And in 2011, China's leadership quashed a \$2 billion corruption scandal in the Railway Ministry centered upon China's bullet train project. President Hu Jintao took office nearly 10 years ago pledging to crack down hard on corruption, but as his term nears its end most people today would say things have gotten



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worse, not better, with the scale of cases that emerge appearing larger and larger.

This is the Chinese environment in which Western multinationals operate. At the same time, they face growing pressure from home-based legislation to comply with their country's anti-bribery laws outlawing the use of bribery in overseas business. It's a Catch-22.

International anti-bribery laws

The U.S. led the way in anti-overseas bribery legislation with the launch of the Foreign Corrupt Practices Act (FCPA) in 1977. The U.S. government didn't use the law much in its early years, but it's enforcing it much more in recent years. The U.S. Department of Justice (DOJ) has pursued and heavily fined a number of major U.S. and other multinationals for violating the FCPA.

Additional laws elsewhere have added weight to this clampdown. An OECD Anti-Bribery Convention (and the resulting 2009 Anti-Bribery Recommendation adopted by 39 countries) and a United Nations anti-bribery treaty mirror the FCPA. And many countries now have introduced national equivalents of these laws, most notably the United

Kingdom, whose Serious Fraud Office is the investigative enforcer. In the U.S., the DOJ has more than 200 bribery cases undergoing or awaiting investigation.

These laws prohibit companies from bribing overseas officials to win business abroad. The definition of *overseas official* in China is applied equally to executives of SOEs. Of course, most multinationals doing business in China have to transact with SOEs on a regular basis. It's nearly impossible to not encounter an official who wants a bribe in cash or kind before granting an order or an approval, or some other kind of assistance or facilitation. Obviously, this is a major obstacle to conducting business in China. Many firms lose business to domestic outfits ready to pay bribes. I've found that the Chinese government mostly turns a blind eye to this type of graft, except in cases with political implications because of its concern to keep the economy moving. With such an uneven playing field, this situation amounts to a non-tariff trade barrier for foreign firms.

Even if a company wants to do clean business, a foreign firm can be a magnet for corrupt employees who'll lead it astray because the language and culture

gap make it quite easy to use crooked practices undetected by management. These practices may include defrauding an employer through procurement and distribution frauds involving bribes or paying bribes to officials to obtain government orders, thus exposing the company to FCPA risks.

FCPA-style laws extend to all sorts of agents; corporations can't legally hide behind an intermediary third party such as a sales agent, distributor, reseller or "consultant" who pays out bribes to end-customers in state-owned entities. Ignorance about their activities isn't accepted as a defense against international anti-bribery laws.

Companies are forced to use self-protective ethics clauses and prohibitions in their contracts and to address FCPA concerns — especially selling practices in their due diligence on third parties, partners and acquisitions, and to respond in a conscientious and robust manner to all allegations, suspicions and reports of bribery within their business. Disclosure is obligatory. There's virtually no legal escape ladder.

The required response to a bribery case can take a brutal toll. In most cases, companies have to engage top-level law firms and forensic firms, and the work is usually large-scale, disruptive, costly and potentially embarrassing. When the investigation shows clearly that bribery has taken place, the company will usually be advised to confess apologetically to the DOJ or Securities and Exchange Commission (SEC) and then attempt to negotiate an out-of-court settlement or plea bargain.

Whistle-blowing complaints or suspicions aroused in internal audits are the common triggers for these investigations. When the alarm goes off, the firm has no legal option other than to contact lawyers, forensic accountants and investigators. Some cases make headlines, with ruinous financial and reputational consequences for the implicated firms.

Others stay out of the news and the courts after narrow escapes.

Narrow escapes and close shaves

I've been involved in a number of investigations that didn't make the headlines.

IT manufacturer

A whistleblower alleged corruption among sales managers at a high-profile IT product manufacturer that sold to government entities. The firm was worried that illicit activity might include acts of bribery that would be subject to the FCPA. Management heard staff rumors. Our



lengthy forensic investigation revealed that senior sales managers were involved in an elaborate extortion racket in which they received kickbacks from systems integration companies that were the de facto distributors of the firm's products.

In this highly regulated Chinese business sector, "distributors" are desperate to get involved in big government orders, so they can earn large sums of money from installing IT systems. Sales managers of the IT manufacturer will choose which integrators to go with and extort payments from them. They conduct the kickback in secret, with "side contracts."

In this case, the sales leader purposely aroused worries about bribes to officials. He thought that the firm would prefer not to investigate something that could lead to an FCPA case. In fact, it was a massive distribution fraud involving kickbacks extorted by their employees. The ringleader was a gambling addict with gang connections. He spent most of his ill-gotten gains on trips to

casinos in Macau where he had affiliations with the triad (underground Chinese criminal groups).

Internal controls failed to detect and prevent malfeasance. Older and senior management overwhelmed a young internal due diligence team and controlled lower-level staff. Management's sales arguments always won against control and compliance logic. A negligent country manager gave tacit nods and winks. Our investigation led to dismissals, contract terminations and substantial write-downs on discredited, risky deals.

We used a multi-disciplined approach in the investigation, which combined extensive online and database trawls; office searches; multi-jurisdictional records retrieval and analysis; computer forensics and massive e-reviews; internal interviews; audit and transaction analysis; handwriting analysis; analysis of forged "chops" (chops, or seals, are used to authorize documents in China by stamping); external undercover inquiries; and simultaneous, multi-location, cross-border surveillance actions. U.S. lawyers, who were specialized in FCPA cases, oversaw the case under attorney privilege.

A typical IT contract involves multiple entities, which provides abundant opportunities to insert parties into the process representing deal "stakeholders" such as salespersons and officials. The complex structure and esoteric nature of IT deals makes it hard for auditors to judge those services that are vital to the deal and those that have been inserted unnecessarily.

The contract documents available to fraud examiners and auditors may look flawless, but the illicit stakeholder interests are hidden away behind the immaculate paperwork. Entities owned by the "stakeholders" have no direct contract with the firm. So internal controllers and external auditors easily missed the scams.

To fight this, the firm should have a field audit and investigation team with a CFE's nose for a bad smell either placed

in-house or as a third-party service that understands such nested relationships and processes and can uncover the people behind these illicit processes and loopholes.

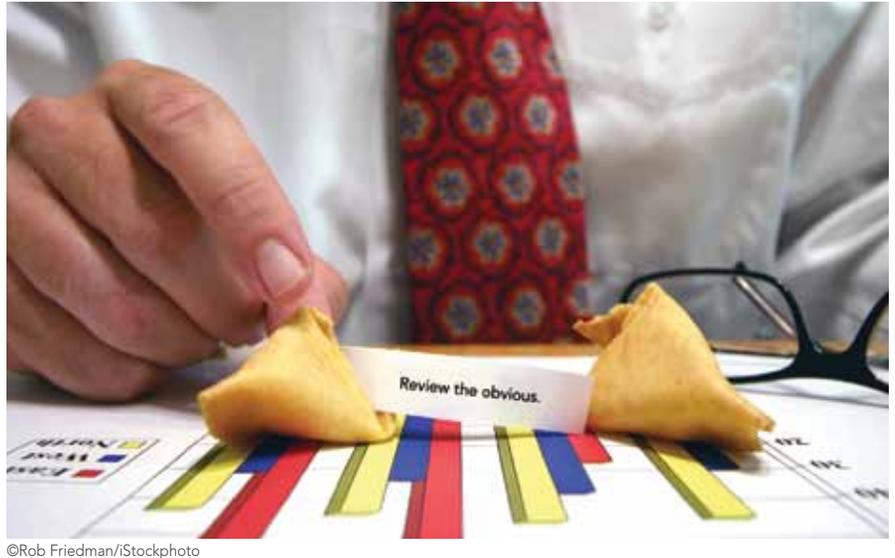
Industrial equipment maker

A U.S. multinational industrial equipment manufacturer with a plant in China learned that its China managing director (MD), general manager, CFO, production chief and chief engineer were all involved in various fraud rackets. After the company investigated the fraud, it dismissed them and hired new managers.

The dismissed MD tried to regain leverage by threatening to disclose knowledge of bribery violations at the China operation. The company then reexamined the MD's tenure history in China in detail. They found there was some basis to his threats.

The firm had many SOEs among its clients. Under the corrupt MD, a local sales agent had been helping SOE bosses take pleasure trips to the U.S. The corrupt MD would officially invite SOE bosses to visit the U.S. factory. Then an SOE would add money to its purchase contract, and the local sales agent would use that money to make the travel arrangements. Officially, the SOE bosses were inspecting facilities, but in reality they only visited for a day and then headed to Las Vegas for a week of gambling and shopping. Sometimes the visits were "canceled," and the firm remitted the money back to the agent to pass to the SOE customer as a "refund."

The visit payments became routine and informal. The company functioned much like a travel agent. Eventually, the SOEs and the company's sales agent stopped writing the visit payment clauses directly into the contracts. Soon the company began giving SOEs refunds on canceled visits that were never written into the contracts. The company had no way to check if the SOE really had paid for the visits.



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The company used the visit payment refunds as a tool for paying kickbacks to the SOE executives. Under the corrupt MD, the local sales agent was funneling tens of thousands of dollars straight into the pockets of these executives.

The company brought in costly FCPA-specialized legal counsel to evaluate its liability and hired our firm to investigate. We again used a multi-disciplined approach. We conducted a detailed e-review of management and staff emails; researched online sources and databases; retrieved and analyzed incorporation records and personal records in China, Hong Kong and the U.S.; analyzed traffic on company-owned Chinese mobile accounts; and conducted internal interviews with managers, the distribution agent, key third parties and external human-source inquiries in China.

We also conducted a detailed e-review of the corrupt MD's email data and uncovered details of the visit payment transactions. We interviewed the sales agent and our client's local staff to ascertain their practices. The corrupt MD was well aware of the kickbacks.

The local sales agent, under legal advice, lost its exclusive agency agreement, and our client introduced tough new controls to curb illicit sales practices. Over the following months, the

company dismissed several more staff who were associated with the scheme. The company didn't prosecute.

Important points from these cases

In these cases, the ability to conduct CFE-style e-reviews and document reviews was crucial to solving the puzzles, but they had to be done with material in a mixture of Chinese and English.

You can do the following:

- Regardless of the countries in which you work, you must understand how business processes work and where the fraud opportunities are. Always think like a fraudster.
- Focus your attention on the people. The morale of ordinary workers is always a useful barometer.
- Use checklists; but don't limit yourself to those lists.
- Don't exclusively trust the Chinese legal tax receipts ("fapiao"), which are widely falsified and misused. They tell you almost nothing certain about transactions.
- Warehouse records and vehicle logs may be better places to look for clues, names, addresses, phone numbers, etc.

- Pay attention to the physical surroundings, the people, the goods and other objects.
- Talk not only to managers but to junior people, too: drivers, janitors, gatekeepers, warehousemen, guards, shop-floor workers. They know things.

Typical corruption clues

- A long-term supplier vanishes, replaced by a new supplier with higher prices and higher volume.
- A buyer fails to respond to a decline in market prices or buys a large volume just before a foreseeable fall in market price.
- An employee never complains about pay, while turnover of other staff in the company is high, and morale is low.
- Favorable payment terms are given to certain suppliers.

- The morale of most employees is low, and people are evasive when questioned.
- There's gossip about rich lifestyles, property purchases, luxury cars and expensive holidays.
- The numbers for certain transactions are conveniently round.

These are just a few corruption clues. There's no magic list; you must play detective every time!

E-reviews

E-reviews are increasingly important in Chinese white-collar crime investigations, especially in cases that raise FCPA concerns. Much communication about bribery is furtive, but you can find it.

Review the obvious: email traffic and work files (Word, Excel, PowerPoint, Adobe files, etc). But you also need to review the less obvious, such as online

chats and SMS (text) exchanges. This data is often harder to get at, but sometimes produces useful results.

Chinese people often mingle languages (for example, Chinese with English at a U.S. firm or German with Chinese at a German firm) even in a single phrase or sentence. File names may be a mix of Chinese and English, which causes havoc for keyword searches.

They use trans-lingual slang and jargon. For example, a Chinese word may be transliterated from Chinese characters into Roman letters (such as 水分, which means moisture — a euphemism for a bribe — becomes “shui-fen” in English) and is then used within English messages in a special way. Or an English name may be transliterated into Chinese characters that sound similar to the English but with a completely different meaning.

Procurement fraud can occur at every stage of the contracting process. *Are you prepared to prevent it?*

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They often use Chinese-language euphemisms and innuendo. Terms like “service fee,” “labor fee” and “transport fee” are sometimes code words for bribes.

Consequently, the fraud examiner or e-reviewer requires a good knowledge of both languages and of the actual business processes (not just the official on-paper business model) within entities.

Preventive measures

To reduce the risks of violating the anti-bribery laws, companies are encouraged to adopt the following measures.

Due diligence with an FCPA focus

The pressure of anti-bribery legislation on corporations is forcing them to give prominence to the FCPA in their due diligence on partners, acquisitions, distributors, etc. They need to do it with CFEs’ eyes. For example, investigative due diligence must include discreet inquiries into sales practices and into ties to government officials, while financial due diligence must look out for signs of slush funds, unusual agent fees and numbers that are too round.

During an acquisition, a firm needs to identify any part of the target’s business that’s won via bribery and discard it. This could mean reducing the acquisition’s value.

Internal controls

Senior management must fully support the internal control function. Otherwise, commercial departments easily overrule the findings of controllers or blame them for lost business. Internal auditors must understand commercial issues and operational processes. They must be able to conduct field inquiries on suppliers or distributors and go beyond clerical accounting.

Checks and balances

A number of people should make buying and sales decisions together. Don’t allow individual buyers or sales representatives an exclusive interface with third-party suppliers and customers.



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Policing third parties

Conduct regular field audits on important suppliers and distributors to ensure their operations and clients are real and not phantoms. It’s not enough to obtain copies of business licenses and certificates because they can be easily faked. The right to audit — even random audits — should be written into business contracts.

Code of conduct and contracts

The company must produce a code of conduct, code of ethics or business practices statement tailored to China and expressed bilingually. You can’t just disseminate your global code in English. Weave the key provisions of the code into all contracts with employees, suppliers, distributors, resellers, all types of agents and joint-venture partners.

Training

Ethics awareness training is essential in China to educate stakeholders to understand and follow the code of conduct, contract provisions and the law. Companies should educate not only their own staff but also their key partners, such as distributors and suppliers.

Hotline

An ethics hotline is vital and must be publicized along with the code of conduct to all staff, suppliers, distributors, customers and other stakeholders. The hotline must provide secure communication channels. In China, in particular, whistleblower anonymity must be guaranteed if a hotline is to be effective. Informers must

provide enough details in their allegations to facilitate inquiries. In China most complaints come by email and sometimes via a phone call. It’s critical to be able to handle complaints and tips in the Chinese language — both written and oral.

Opportunities for CFEs in China

The high incidence of bribery and fraud in China and the pressure from international anti-graft laws present a major opportunity for CFEs to sell their skills to corporations with China operations.

On the commercial side, CFEs will find opportunities as in-house staff or as external consultants with corporations, law practices and investigation firms focused on China. There may also be a role for CFEs with some China specialization in Western government agencies involved in anti-corruption probes.

CFEs who already know the Chinese language or who are willing to learn it, and people with Chinese language skills who are interested in training as CFEs can play pioneering roles. ■ FM

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