



Laying down the law

**Western companies in China toe the line
between corruption and compliance**

“Inside Job,” a US film about corruption at the nexus of politics and business, was selected as one of 21 documentaries to be played at this year’s Beijing International Film Festival. It proved an uncannily prescient choice.

The festival had its best year ever, drawing studio producers and directors from around the world, many of whom are banking on China to sustain growth as North American box office receipts slump. Beijing allows just 35 foreign films into Chinese theaters each year, making each quota potentially worth millions of dollars. To obtain licenses, studios and producers must “play by the rules that are internal to this market,” as director James Cameron put it. This includes currying favor with regulators by self-censoring their material, partnering with local companies and – it is widely suspected – giving some gifts.

Shortly after the festival concluded, news broke that the US Securities and Exchange Commission (SEC) was preparing to launch an investigation into several major Hollywood studios for corrupt practices in China. Many Western businesses with operations in China are now following the case closely – though less out of interest in studio antics than their own fates.

With the UK strengthening its anti-bribery laws and the US stepping up enforcement of the Foreign Corrupt Practices Act (FCPA), small and medium-sized companies have found themselves in government crosshairs for the first time. Many are now concerned that succeeding in China’s business world requires them to risk possible prosecution back home.

“These are two trains headed at each other down the track,” said William McGovern, a former SEC enforcement official who is now a Hong Kong-based partner at law firm Kobre & Kim. “It really does create a very uncertain environment for firms in China.”

Chinese characteristics

China’s business world is known for bribery and shady dealings, and studies indicate that reputation is deserved. The country ranks 75 out of 182 countries on Transparency International’s Corruption Perceptions Index, a gauge of general corruption. The Bribe Payer’s Index, a survey which measures how likely companies in certain countries are to engage in bribery, places China a miserly 27th out of 28

countries, ahead of only Russia.

China’s culture of *guanxi* and gift-giving is sometimes given as a reason for the country’s pervasive corporate corruption, but weak rule of law and unpredictable enforcement are at least as important.

“The reason you see more corruption in China is that it’s just harder to fudge the figures in the US – companies that do [in the US] typically get caught by their auditors or the Internal Revenue Service,” said Andrew Wedeman, a professor of political science at Georgia State University who researches corruption in East Asia. “In China, companies keep multiple sets of books, they operate through shell companies, and the accounting is simply much looser, which make it much easier to engage in company-to-company corruption.”

In this environment, Western firms often wind up the victim – not perpetrator – of corporate wrongdoing, said Peter Humphrey, Beijing-based managing director of ChinaWhys, a risk consultancy. “Many [Western executives] don’t know what is actually happening on the ground in China. There’s a blindness,” he said. “They become magnets for bad people and bad companies – their suppliers, distributors, JV partners and so on.”

Humphrey cited a typical case his firm worked on in which a US company had acquired a Chinese manufacturer. A year after the purchase, costs at the Chinese factories rose inexplicably while profit plummeted. The US company eventually discovered that executives of the acquired company had been manufacturing more products than they recorded and selling the surplus on the side, saddling the company with unrecorded extra costs.

Chinese sales and procurement divisions are especially vulnerable to fraud and corruption, say due diligence analysts. The most egregious cases involve “phantom suppliers”: Employees set up fake companies that act as middlemen between a foreign company and its domestic suppliers, taking a slice of every transaction in between. “These types of fraud are very hard for senior partners to spot unless there’s a whistleblower,” Humphrey said.

Many foreign companies also struggle to control kickbacks and gift-giving among their Chinese staff. Salespeople often have the attitude that palm-greasing is just “a fact of life” in China – an attitude that makes corruption hard to stamp out. >>



‘Asian witness can find it hard to understand why mooncake gifts – a centuries-old tradition – are the subject of such careful scrutiny’
-WILLIAM McGOVERN, KOBRE & KIM

>> US cosmetics company Avon Products, for example, is currently in court in the US over allegations that its Chinese employees bribed local officials for licenses to conduct door-to-door sales. Staff then disguised the bribes as invoices to third-party consultants. The firm’s New York headquarters discovered the incidents when it performed an internal audit.

“If you’re a [Western] company with 20 Chinese salespeople and they have to go out into the provinces to sell pharmaceuticals or whatever – how are you going to stop it?” asked Dan Harris, a Seattle-based lawyer at Harris & Moure, who works with small- and medium-sized companies in China on FCPA compliance.

Experts say the pharmaceuticals industry is particularly prone to palm-greasing. Each of China’s 31 provinces and municipalities individually approve

new drugs (a job handled in most other countries by a single national agency). Both regulators and doctors – who are usually state employees – present tempting targets for under-the-table deals.

Western pharmaceutical executives have pledged to stamp out corruption among their Chinese staff. Yet in 2010 the US Department of Justice (DoJ) launched an ongoing investigation into AstraZeneca, GlaxoSmithKline and other pharmaceutical giants for allegedly violating the FCPA in China.

Doing good by doing well

Western companies have had a long time to get used to basic bribery legislation. The US passed the FCPA in 1977, and many other jurisdictions have since followed suit. Some 39 countries are signatories to the “Convention on Combating Bribery of Foreign Public Officials in International Business Transactions,” a similar directive promoted by the Organization for Economic Cooperation and Development (OECD).

Rules against foreign corruption, however, have become more expansive in recent years. The UK Foreign Bribery Act, which came into effect in July of last year, casts a much wider net than the FCPA, said Mike Thompson, Professor of Management Practice at the China Europe International Business School. While America’s SEC and DoJ – the two government agencies charged with enforcing the FCPA – prosecute only

firms which bribe foreign officials, the UK’s Serious Fraud Office is allowed to pursue corruption of any kind, official or private, among any company that carries out business in the UK.

More importantly, enforcement of anti-bribery legislation has increased dramatically in recent years. From its inception until around 2007, few governments sought out and prosecuted offenders. Many countries which signed the OECD anti-bribery convention simply ignored the rules. For all its far-reaching implications, no high-profile companies were prosecuted under the UK Foreign Bribery Act. Even in the US, in most years only a handful of companies were prosecuted under the FCPA.

About five years ago, however, the attitude in the US shifted. The SEC and DoJ became “much more aggressive [and] interested in ferreting out every example of improper payments to government officials anywhere in the world that can be connected back to the US,” said McGovern of Kobre & Kim. In 2003, authorities initiated zero actions under the FCPA; by 2010 the figure had risen to 74.

Penalties for companies caught in the act can be steep. FCPA fines amount to an average 9% of company earnings before interest, tax, depreciation and amortization, according to a study by Jonathan Karpoff of the University of Washington, D Scott Lee of Texas A&M University and Gerald Martin of American University. For public companies, the damage to their share prices can last for years.

But actual prosecutions represent only a fraction of total FCPA cases. The SEC and DoJ do not have enough resources to go after every suspected offender; rather, they rely on companies to root out and report corruption within their own operations in exchange for lower fines, McGovern said.

This drive to encourage self-reporting may explain why the SEC chose to target Hollywood in China, said Harris of Harris & Moure. By devoting its resources to prosecutions involving large, high-profile companies that land on the front pages of newspapers, regulators can reap a windfall from the countless smaller companies that are cowed into self-reporting.

“There’s an expression in golf that you drive for glory, and putt for dough,” said Harris. “Going after the movie industry is for show. The dough comes when you >>

US Foreign Corrupt Practices Act (FCPA) cases and settlements, 2003-2011



► Smoke screen: New limitations on information make investing in China even trickier

Like many Western investors in China, consultant Michael Johnson had an “eye-opening experience” advising a large US company in its acquisition of a smaller industrial technology firm in China. The managing partner at ChinaBridge Advisors initially thought the Chinese company seemed like the perfect target, with a good business model, up-to-date technology and competent staff.

As the deal progressed, however, Johnson learned that the target, a former state enterprise, had plenty of hidden baggage. Its corporate structure was complex and unwieldy, and management kept multiple sets of accounting books (probably to dodge taxes). The US company had a hard time understanding the company’s financials, much less independently verifying them.

The deal eventually fell through, partly out of concern that management would have difficulty justifying a valuation based on unofficial records to shareholders back in the US. The example goes some way toward explaining why the interpersonal relationship – so-called *guanxi* – is pivotal to business in China.

“It has to be,” said Johnson. “In the US, the predictability of enforcement of rules allows for a comfort of doing transactions even when you don’t have a deep relationship or trust with the other party.” In other words, prospective investors in China need to do their own homework to know who they’re doing business with.

Private eyes for hire

Unfortunately, many foreign companies don’t have the time or resources to build intimate relationships halfway around the world. “There’s a huge time factor,” according to a Shanghai-based Western consultant who advises private equity firms. “Some [private equity] investors take so much time poking around a Chinese company, it’s snapped up by someone else before they finish.”

“Everyone [in the Chinese Communist Party] is now scared the same could happen to them – if they could do it to Gu Kailai, they could do it to anyone”

-DUE DILIGENCE ANALYST

Instead foreign companies turn to China’s booming due diligence industry to vet potential partners. These investigators – including large global firms like Control Risks, Kroll and Nardello and Co, as well as a host of smaller companies – are contracted to assess Chinese companies before a takeover or spot fraud in the Chinese operations of Western multinationals.

Such tasks are normally the job of audit firms, but due diligence experts insist that auditors in China are inexperienced and out-matched by local fraudsters. “They’re number crunchers – they want to match numbers,” said Peter Humphrey, Beijing-based managing director of ChinaWhys, a risk consultancy. “They don’t notice the two Ferraris parked at the door when they come in for the audit.”

Due diligence experts use many tools to investigate operations for signs of fraud and corruption, including verifying invoices and interviewing former employees. The most common method, however, seems to be acquiring corporate information from the local bureaus of the Administration of Industry and Commerce (AIC). Technically, only Chinese lawyers, police and other government officials are allowed access these files, which contain information on corporate addresses, registered capital, shareholders and so on. However, many due diligence insiders say the information is readily available through back channels for a price.

Plumbing the leaks

At least, it was until recently. Local AIC

bureaus in Shandong, Tianjin and Beijing have officially introduced rules that will bar such information without a written request from the company under investigation. Unofficially, industry insiders say that the availability of AIC files has plummeted even through back channels, and in some cases dried up completely.

Why the abrupt change? One theory is that the AIC’s screws have been gradually tightening since the high-profile accounting blowups of some Chinese companies listed abroad last year, most notably Sino-Forest and Longtop. The scandals embarrassed Chinese trade officials and diplomats, who plugged the AIC leaks to avoid a repeat.

A competing theory is that the clamp-down is related to a recent probe into Dun & Bradstreet, an American business information firm which is alleged to have acquired and sold private information on Chinese individuals and companies. The firm is now under investigation by the US Securities and Exchange Commission for a possible violation of the Foreign Corrupt Practices Act.

Others, however, point to a more immediate cause. On April 14, Bloomberg published a damning account of the family wealth of former Politburo member Bo Xilai and his wife Gu Kailai, tracing the many conglomerates, family pseudonyms and shell companies of the disgraced couple. Much of the information Bloomberg reported is thought to have been acquired from the AIC. “Everyone [in the Chinese Communist Party] is now scared the same could happen to them – if they could do it to Gu Kailai, they could do it to anyone,” said one due diligence expert.

Whatever the reason for the changes, they could have wide ramifications for foreign investors. Corporate filings are often the only “smoking gun” which foreign companies can use to prosecute wrongdoers.

It is too soon to speculate if this loss will lead to more fraud or failed deals, but those inside the industry agree the change does not augur well. “It’s a dark day for [the] due diligence [industry],” said one source involved in due diligence. “It’s a dark day for investors.” ♦



► Strong arm of the law: China's commercial corruption laws are undermined by politically driven enforcement

Penalties for violating anti-bribery laws in the US and UK may be harsh, but they have yet to include capital punishment. The same cannot be said of China: In November 2011, the former head of Shanghai Pharmaceutical Group was handed a death sentence for embezzling RMB50 million (US\$7.9 million), though the sentence was later suspended.

Such extreme punishments for corporate wrongdoers might be an effective deterrent in other countries. In China, however, politically motivated and patchy enforcement often undercuts their effectiveness.

Bending the rules

China's current law governing corruption among businesses – as distinct from traditional official corruption – was effectively created in 2006. State media announced that scores of officials and business executives had been arrested and billions of yuan recovered, all thanks to powers granted by the new law.

"[Authorities] were suddenly dealing with about 6,000 cases [of commercial corruption] a year," said Andrew Wedeman, a professor of political science at Georgia State University and author of a paper on the crackdown.

But it was clear that the new regulations had simply shifted some of the blame for corruption from government officials to corporations. While the number of commercial cases had risen, overall incidents of corruption appeared to be about the same, Wedeman said.

"If you actually look at the statistics, it's actually clear that they were dealing with about 6,000 cases a year before that," he said. The government had simply re-classified cases that were previously labeled as official corruption – especially involving state-owned enterprises – as commercial corruption.

Legal analysts describe the corporate corruption law – and an anti-foreign bribery law passed last year – as scattered and unclear.

For example, the law says companies cannot use "property" to "pursue

improper gain." But China's definition of "property" stretches well beyond that of other countries and can be used to prosecute even benign transactions, said James Xu, a lawyer at Sunjun & Associates who works on commercial corruption cases. "The vaguely-defined and subjective criteria create a dilemma for what constitutes bribery and the punishment," he said.

Some ambiguity in the law is intentional. A Supreme People's Court opinion issued in 2008 said judges should be given leeway to determine the definition and penalty for bribery, depending on the specific circumstances of each case. Flexibility in corruption laws is hardly unique to China, and it can work well in countries with an independent judiciary. In China, however, it paves the way for partial and politically-motivated enforcement.

In addition, agencies charged with enforcement can pick and choose who to target. Companies in sensitive industries, such as pharmaceuticals and healthcare, have been subject to disproportionate scrutiny in China, as have foreign companies. Of the 500,000 corruption investigations undertaken in China between 2000 and 2009, 64% involved foreign companies, according to a 2010 study by Anbound Group, a Beijing-based consulting company.

In extreme cases, local authorities have raided the offices of foreign firms and accused them of commercial corruption, then asked for a bribe to make the problem go away, said one Shanghai-based due diligence expert, who asked not to be named for fear of recrimination.

Because corporate kickbacks and bribery are so pervasive, Beijing likes to hand out severe punishments to perpetrators it does catch in order to "send a message" to the market, Thomas Shoemaker, head of China practice at law firm Pillsbury Winthrop Shaw Pittman, wrote in a note to clients.

But if enforcement remains sporadic and politically driven, it is unclear what message is being sent. ♦

>> get money from everybody who hears about it and says, 'I better self-report, I better clean up.'"

The tactic appears to be working. Harris said his clients have lately become increasingly worried about their exposure to FCPA legislation.

For many small- and medium-sized companies, complying with the FCPA is a new challenge. The rules were once thought to pertain only to small, corrupt countries that had little trade with the US. But as the regulator began going after Chinese operations, the potential pool of affected US companies grew much wider. Around 17-22% of all FCPA prosecutions now involve alleged malfeasance in China – second only to Nigeria, according to Jenny Jiang, vice president at the Chinese Academy of International Trade and Economic Cooperation, part of the Ministry of Commerce (MOFCOM).

Sharing the pain

Giant multinational companies like movie studios, Wal-Mart and Siemens may be the targets of the most official FCPA prosecutions and pay the largest fines. However, it is small and medium-sized firms that are likely to be hurt most by anti-bribery laws.

For example, a large company considering a US\$200 million dollar transaction would clearly have the financial incentive to pay US\$10,000 to have a team of lawyers ensure FCPA compliance. By contrast, Harris of Harris & Moure said he sometimes feels compelled to advise smaller companies working on a US\$200,000 transaction that ensuring compliance is uneconomical. Better to simply drop the deal and forgo what could have been legitimate profit. Of course, some companies simply go ahead and hope not to get caught.

Extra compliance costs aside, small businesses worry that tight regulation could make them uncompetitive in China's business culture. The FCPA is ambiguous on many issues. Are all employees of state-owned enterprise considered "state officials"? Bribing officials for public contracts is obviously a violation, but what about paying a low-level official to process paperwork that he should be responsible for anyway?

The rules are meant to give federal prosecutors some leeway and negotiating power with companies under investigation. Agencies can adjust fees based on how much the bribe was worth, who was

being influenced and how senior the perpetrators were.

Yet these legal ambiguities may allow determined prosecutors to punish companies for practices most Chinese businesspeople would consider innocuous. "I've been in witness interviews where the government goes through excruciating details with the head of event planning, for example, about mooncakes that might have been given to government officials," said McGovern of Kobre & Kim.

"As Asian witness can find it hard to understand why mooncake gifts – a centuries-old tradition – are the subject of such careful scrutiny."

Harris of Harris & Moure said federal authorities are looking to "teach" other companies in the industry a lesson and might soon decide to ramp up fines if the message doesn't seem to be getting through. "If you're the first one to be caught in the retail sector, the penalty might not be as steep as if you're the fifth," he said.

Other legal analysts agree that penalties will increase in coming years, though for different reasons. A 2010 report by Bruce Hinchey of the George Wash-



HEAR ME ROAR: Guarding the gates of an anti-corruption bureau

ington University Law School examined 40 FCPA cases between 2002 and 2009, and found that firms which self-disclosed actually paid higher fees on average than those that tried to get away with corruption but were caught. This has led some industry observers to call for "better incentives" to encourage self-disclosure, such as higher fines for companies that

are found guilty.

The advantage to federal discretion, however, is that prosecutors go easier on firms which demonstrate generally sound compliance systems and a culture of integrity, said McGovern. Judges and juries in some FCPA cases have recognized that "rogue" employees do exist in China and reduced penalties. >>



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CHOP SUEY: A police officer confiscates fake chops, used to falsify tax invoices, in a raid in Xi'an, Shaanxi province

“There’s an expression in golf that you drive for glory, and putt for dough. Going after the movie industry is for show. The dough comes when you get money from everybody who hears about it and says, ‘I better self-report, I better clean up.’”

-DAN HARRIS, HARRIS & MOURE

instead,” he said.

Siemens is often held up as proof that a Western company can clean up its China operations and still succeed in the market. Between 2001 and 2007, the firm was convicted of making some 4,283 bribes amounting to US\$1.4 billion. A culture of corruption was rife in every part of the firm; scandals involved operations in Argentina, Venezuela, Vietnam and China.

But after paying a US\$1.6 billion fine to US and German prosecutors, Siemens revamped its 200,000-employee corporation, replacing nearly all of its board, hiring hundreds of compliance officers and re-training its existing staff. Corporate governance experts now praise its über-compliance program.

“They’re actually marketing their compliance, and it’s winning them new customers in China,” said Humphrey of ChinaWhys. “You can be clean and do business here.”

Small businesses occupy market positions very different from Siemens, however, and many cannot afford expensive compliance programs. They are likely to struggle to stay competitive with local rivals that are fiddling with their invoices and giving big clients “red envelopes.” “It’s by far the biggest concern I hear from clients: ‘How can we compete on this contract when everyone else is paying up money?’” said Harris of Harris & Moure.

“My response is, ‘I don’t know, but I do know it’s not worth going to jail over this project.’ They always agree with that.” ♦

>> The UK Bribery Act has similar standards. Officials do not realistically expect huge British multinationals to ensure compliance among thousands of local Chinese suppliers, said Thompson of CEIBS. Instead, the goal is to encourage a good-faith effort to do all that is reasonably possible to prevent bribery in the supply chain.

Compassionate compliance

Yet some businesses still doubt their ability to remain competitive in China while also making a good-faith effort to eradicate corruption. Others argue that they can, because China’s corporate culture is itself becoming cleaner – albeit slowly. “It’s gradually filtering from top to bot-

tom,” said Thompson of CEIBS. “There’s no way the big companies can get away with [systematic fraud] today.”

Wedeman of Georgia State said China’s corporate governance will probably improve as rule of law strengthens and companies realize that renegeing on contracts does not pay in the long term. The development of other East Asian countries suggests that while commercial corruption may not go away entirely, it will become less frequent and overt.

“You would never deliver a box of 100 renminbi notes to a Japanese CEO – he’d be shocked,” Wedeman said. But there are still ways in which companies can scratch each others’ backs. “How could you do this? Hire my cousin