
Anti-corruption, ethics and compliance in China

Learn how to have a successful anti-corruption strategy

Executive Summary

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Ethical Corporation Institute

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Foreword

Nearly every industry is taking advantage of low operating costs in China. However, few companies have effectively evaded all corruption risks.

Our research at the Ethical Corporation Institute supports a number of external studies on corruption in the region. 2008 figures published by Transparency International rank China as having one of the most corrupt operating environments. It scored 3.6 out of a possible 10 points in the Corruption Perceptions Index - below 5 indicates a serious corruption problem exists within the public sector. In addition, China earned a score of 6.5 (out of an optimal 10) on the Bribe Payers Index, placing them 21 out of 22 leading international and regional exporting countries.

Our research found that most senior foreign executives working in country for any substantial period of time had encountered corruption or malfeasance in some form. This briefing aims to equip executives with the information and tools to reduce such risks.

Although corruption remains a significant obstacle to company operations, anti-corruption efforts are making some headway. The majority of executives interviewed for this report expressed confidence that corruption can and is being reduced in China.

The national government, lead by the Chinese Communist Party, has demonstrated a commitment to reducing high levels of corruption through action. Official laws are far from specific, but do address corruption more directly than laws in some countries. Corruption is specifically addressed in national laws such as the Chinese Criminal Law, the Corporate Law, and in commitments to a number of international conventions such as the United Nations Convention against Corruption.

The Ethical Corporation Institute (ECI) is grateful to in-country researchers and all corporate representatives for providing significant insight and co-operation during interviews.

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Executive summary

Despite considerable progress in the fight against corruption, China remains highly vulnerable to ethical and compliance violations. Multinational companies routinely face corruption-related challenges in their mainland China business operations, either through local staff, joint-venture (JV) partners or other affiliates such as vendors, agents, suppliers and/or distributors. It is also clear that the problem does not go away when foreign companies incorporate in China as Wholly Foreign Owned Enterprises (WFOEs).

Transparency and anti-corruption initiatives are notably more prevalent - and increasingly effective - in China's coastal provinces, particularly the Yangtze River Delta (YRD) in eastern China, the Beijing-Tianjin Corridor (BTC) in northern China and the Pearl River Delta (PRD) in southern China and bordering the Hong Kong Special Administrative Region (SAR) where foreign investment has been most sustained and concentrated over the past 30 years since the inauguration of Premier Deng Xiaoping's 'Reform and Opening Up' programme in 1979. Multinational companies operating in the less developed inland provinces of China frequently come across corruption issues not only with local companies but also the provincial or city authorities and officials where they are operating. In some cases the relationship between the authorities, officials and local companies is blurred to the point where protectionism becomes inevitable. In such environments, intellectual property (IP) protection is a particular concern for multinational companies.

It is fair to say that most senior foreign executives working in-country for any substantial period of time have encountered corruption or malfeasance in some shape or form in China at least once. Some of the senior executives interviewed for this briefing had only heard of the problems it can cause; others had

experienced them personally at first hand. Corruption issues range from small cases of bribery to circumvent bureaucratic hassles to major bribes and gift giving in order to secure major business contracts.

Most of the executives interviewed believe that China has come a long way in creating a more effective environment of legal-regulatory compliance and have gone some way to raising local ethical and compliance standards to those approaching international levels. However, China's traditional business culture of working closely with family or friends illustrates the fundamental importance of personal relationships and trust, with somebody's word often replacing written contracts – an unimaginable scenario in the U.S.A. or the European Union (EU). The cultivation and maintenance of good relationships, or “guanxi” as it is known in Chinese, is central to Chinese business and becomes that much easier if conducted amongst friends and family rather than with strangers. Hence Chinese business culture has further to go in reaching compliance with rigorous international compliance regulations such as the Foreign Corrupt Practices Act (FCPA) of 1977 and the more recent Sarbanes-Oxley Act (SOX) of 2002, both now applicable in the U.S.A.

Importantly, most of the executives interviewed for this briefing are positive about China's ability to continue and complete this process of tightening up legal-regulatory procedures, though, crucially, some interviewees expressed doubts about enforcement and the underlying nature of Chinese business – that it fundamentally relies on mutually beneficial relationships (and by implication, some form of corruption to oil the wheels) in order to succeed. As is often the case in China, while the laws exist on the statute books, effective enforcement through the legal system is often lacking.

Introduction

Like any emerging market, China suffers from corruption and an often unethical business environment. What makes China different from many other national economies is the scale of the bureaucracy and the pace of economic development from a low base, both of which have created conditions ideally suited to the growth of corruption and opportunities for massive financial gain by underpaid local government officials and by entrepreneurs eager to amass personal fortunes as quickly as possible.

Multinational companies looking to adhere to regulatory standards in their mainland China operations often discover that the compliance environment is not particularly robust and that concepts such as corporate governance, fiduciary duty and overall business ethics have yet to evolve. According to one multinational manager based in Shanghai, the Chinese have been doing business with family and friends for hundreds of years, so they have further to go in complying with international compliance regulations. There is clearly an embedded culture that needs to be changed. It should come as no surprise, then, that related-party transactions are commonplace and bribery in commercial dealings routine.

Making things worse are the actions of multinational management, who at a senior level are still largely ex-patriots, who, having a limited understanding of local conditions and the language, opt to leave investment and operational decisions to their local Chinese managers. The head of a Japanese manufacturing operation setting up in China that faced allegations of fraud within its organisation in eastern China discovered that its most senior local manager - a long-serving Japanese-speaking employee who had previously lived in Japan - was defrauding the company on a massive scale by selling surplus, reject and returned product back into the market. Japanese senior management's ignorance of Chinese and English language requirements had forced them to rely too heavily on one individual within the company with disastrous consequences.

Multinational companies which have been in China for decades are also targets. In a typical case in 2007, a well-known European consumer goods manufacturer received poison-pen letters alleging fraud by senior sales managers within the company. It subsequently emerged that a network of local managers, who had known each other since their university days, were defrauding the company through various methods including setting up shell distribution companies through which they channelled product en route to the retailer. The

company was only one in a long line of former multinational employers that had been defrauded using exactly the same methods. Afraid to disrupt its business even more than it already had and risk anti-foreign feeling exploding in the office, the company allowed the managers to resign without attempting to press charges.

In recent years, and notably since accession to the World Trade Organisation (WTO) in 2001, the Chinese government in Beijing has sought to enforce its own increasingly tough legislation governing corruption and 'economic crimes' (which are subject to the death penalty in China). In 2006 the head of the State Food and Drug Administration (SFDA - the government watchdog body responsible for monitoring food and drug safety) was executed for approving untested medicine - including an antibiotic that killed at least ten people - in exchange for cash payments.

The authorities have cracked down on local business people too, not least because of concerns about social unrest sparked by fake investments and pyramid schemes. In 2007 a local entrepreneur received a death sentence in north eastern China for defrauding investors in a would-be ant-breeding scheme. The man had promised returns of up to 60% for investors who purchased ant-breeding kits from two companies he ran. The insects were to be used in traditional medicinal wines, herbal remedies and aphrodisiacs. The business attracted more than 10,000 investors between 2002 and 2005, when investigators finally shut it down. The closure set off a panic among small-time players who saw their life savings disappear overnight (many were laid-off industrial workers using their meagre redundancy payments), prompting the authorities to take swift action to restore 'social harmony' - Beijing's number one political priority.

Meanwhile, household names have also fallen foul of increasingly strict anti-corruption and compliance regulations. The former chairman of Guangdong Kelon Electrical Holdings, once China's biggest refrigerator maker, received a 12-year jail term for falsifying and withholding information and for embezzlement of up to US\$49m. Guangdong Kelon was subsequently acquired by Qingdao Hisense Air-Conditioning Company¹. More recently, the founder of Beijing-based Wumart Stores Inc, a major supermarket chain based in the capital, has been found guilty of corruption and jailed (see Section 3: Case studies), while, Huang Guangyu, the founder of consumer electronics giant Gome (one of the country's largest retailers), and reportedly China's richest man, has disappeared amidst rumours of

corruption and stock market manipulation related to Gome's share price.

Those familiar with China's internal politics were not surprised by Huang Guangyu's detention. In fact it has happened before that high profile Chinese business people who had become household names have been found guilty of corruption and ethical lapses. Before Huang, the most famous case in China had been that of Yang Bin, the Chairman of Euro-Asia Agriculture, a large agri-business company specialising in growing orchids and based in the north-eastern city of Shenyang. Yang had become the richest man in China, a "poster boy" in the Chinese press for Chinese entrepreneurship and Euro-Asia had spectacularly listed on the Hong Kong Stock Exchange (HKSE). Euro-Asia continued to grow to include substantial greenhouse operations across north-eastern China, a theme park in Shenyang and, most controversially, close business links with neighbouring North Korea. However, Yang was found guilty of various corruption

related offences and failure to pay tax and was very publicly jailed for 18 years in 2002.

As its global profile grows, China is aware of its international regulatory obligations. A series of high-profile corporate scandals amongst U.S. - and European-based multinational companies over the past decade and subsequent legislation to regulate business have heightened international scrutiny of multinational companies worldwide. The U.S. FCPA, which outlaws bribery of government officials worldwide and which actually came into force in the U.S. back in 1977, is enjoying a new lease of life as the Securities and Exchange Commission (SEC) uses it to fine U.S.-registered, U.S.-invested or U.S.-listed companies for non-compliance in countries around the world. And according to the China-based manager of one multinational fined for FCPA violations, the SEC and U.S. Department of Justice (DOJ) closely scrutinise violators for signs of improvement and full compliance.

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