

CHAPTER 1 CONCEPT AND SUBSTANCE OF COMMERCIAL BRIBERY

Definition of Commercial Bribery	¶100-000
Substance of Commercial Bribery	¶100-025

Definition of Commercial Bribery

Changes in Definition of Commercial Bribery	¶100-000
Commercial Bribery in Narrow Sense and Broad Sense	¶100-005
Commercial Bribery in Narrow Sense	¶100-010
Commercial Bribery in Broad Sense	¶100-015
Tips for Practice	¶100-020

[¶100-000] Changes in Definition of Commercial Bribery

In the early stages of addressing bribery issues in China, the concept of commercial bribery covered only bribery between business operators, which is commercial bribery in its narrow sense. As the market economy grew, this narrow application was insufficient to safeguard competition. Consequently, the definition of commercial bribery has been broadened to include bribery in commercial activities.

[¶100-005] Commercial Bribery in the Narrow Sense and the Broad Sense

Broadly speaking, any bribery act in commercial activities, including those in official commercial activities, can be regarded as commercial bribery. Therefore, state functionaries fall within the ambit of commercial bribery as well.

In its most narrow sense, commercial bribery differs from bribery more broadly because it specifically addresses bribery acts committed by non-state functionaries in economic activities.

[¶100-010] Commercial Bribery in the Narrow Sense

Commercial bribery is narrowly defined in the *Interim Provisions on Prohibition of Commercial Bribery* (enacted on 15 November 1996) adopted by the State Administration for Industry and Commerce ("SAIC") in light of the *Anti-unfair Competition Law of the People's Republic of China* ("PRC") ("Anti-unfair Competition Law", enacted on 1 December 1993).

Article 8 of the *Anti-unfair Competition Law* provides that: "business operators shall not use properties or other methods to bribe others in order to sell or purchase commodities. A business operator who offers off-the-book kickbacks in secret to another entity or individual shall be guilty of offering a bribe and punished accordingly. Any entity or

individual that accepts off-the-book kickbacks shall be guilty of accepting a bribe and punished accordingly."

Article 2(2) of the *Interim Provisions on Prohibition of Commercial Bribery* provides that: "for the purpose of these Provisions, commercial bribery refers to a business operator's bribery to another entity or individual with property or by other means in order to sell or purchase commodities."

According to these provisions, commercial bribery only refers to bribes offered by business operators to counterparties to sell or purchase commodities, which is commercial bribery in its most narrow sense. Due to the growth of the economy, this application has become insufficient to safeguard market competition.

[¶100-015] Commercial Bribery in the Broad Sense

According to the *Criminal Law of the PRC* ("Criminal Law", enacted on 1 October 1997), *Opinions of the Supreme People's Court and the Supreme People's Procuratorate on Several Issues Concerning Application of Law in Crime of Accepting Bribes Cases* (enacted on 8 July 2007), and *Notice of the Supreme People's Court and the Supreme People's Procuratorate on Issuing the Opinions on Issues Concerning the Application of Law in Handling Criminal Cases of Commercial Bribery* (enacted on 20 November 2008), commercial bribery crimes include ten offences provided in the Criminal Law:

- (1) crime of accepting bribes committed by non-state functionaries;
- (2) crime of bribing non-state functionaries;
- (3) crime of accepting bribes;
- (4) crime of accepting bribes committed by legal entities;
- (5) crime of bribing;
- (6) crime of bribing legal entities;
- (7) crime of introducing bribery;
- (8) crime of bribing committed by legal entities;
- (9) bribery crime of influence; and
- (10) crime of bribing state functionaries of foreign countries or international organisations.

Furthermore, the *Opinions on Issues Concerning Correct Policy Boundary in the Special Project of Controlling Commercial Bribery* issued by the Central Leading Group on Controlling Commercial Bribery provides that:

"Commercial bribery means offering or accepting property or other interests to provide or obtain business opportunities or other economic interests, in violation of fair competition principle in commercial activities."

According to the above provision, commercial bribery in its broadest sense means all bribery acts that can occur in business.

¶100-020] Tips for Practice

- (1) According to the judicial practice in China, commercial bribery broadly includes bribery between business operators, as well as bribery in official commercial activities. It is worth noting that in the Chinese legal system, the definition of state functionaries is broader than that of civil servants.

The definition of state functionaries will be discussed in detail in the subsequent chapters of this book.

- (2) To prevent commercial bribery, companies may include anti-commercial bribery clauses in their contracts.

An anti-commercial bribery clause is used to prevent the supplier from bribing the relevant employee of the purchaser, who is in charge of procurement, by giving bribes such as kickbacks, gifts, free tours or third party payment, etc., to gain an improper business advantage.

The terms of the anti-commercial bribery clause depend on the company's position in the transaction. Generally speaking, the key elements of an anti-commercial bribery clause include:

- a. the definition of commercial bribery;
- b. the definition of third-party payment; and
- c. sets forth procedures and punitive consequences.

See the anti-commercial bribery clause below from a Purchase Framework Agreement, as an example:

Article 6 Anti-commercial Bribery Clause

6.3 Supplier agrees, where supplier or its representative has committed any one of the following acts, Purchaser has the right to terminate this contract immediately, and all resulting liability shall be borne by the Supplier:

- 6.3.1 Offering gifts, stocks, coupons with value greater than RMB1000 per person, or providing any other incentive equivalent to the above-mentioned amount to the Purchaser; or
- 6.3.2 Accompanying or arranging the Purchaser to engage in gambling, pornographic activity or other illegal activity, expressly prohibited by Chinese law.

Substance of Commercial Bribery

Lopsided View of Commercial Bribery	¶100-025
Commercial Bribery Constitutes Unfair Competition	¶100-030
Key Characteristic of Commercial Bribery	¶100-035
Tips for Practice.....	¶100-040

¶100-025] Lopsided View of Commercial Bribery

Article 2 of the *Interim Provisions on Prohibition of Commercial Bribery* provides that: "For the purpose of these Provisions, commercial bribery means bribes in the form of property or other means, offered by business operators to counterparties in order to sell or purchase commodities." This provision defines "commercial bribery" as "bribes", which does not shed any light on the substance of commercial bribery.

In judicial practice, many people are of the view that any incentive offered by business operators during the sales or purchase of commodities constitutes commercial bribery. However, we believe that this is a lopsided understanding of commercial bribery.

Generally, the law enforcement and business operators fail to truly understand the substance of commercial bribery in the context of unfair competition. A comparison to other unfair competition activities helps to understand the nature of commercial bribery.

¶100-030] Commercial Bribery Constitutes Unfair Competition

Business competition has many aspects. Proper competition mainly includes competition on product quality, price, talent and technology.

According to the *Anti-unfair Competition Law* (enacted on 1 December 1993) and the *Anti-monopoly Law of the PRC* (enacted on 1 August 2008), unfair competition primarily includes:

- (1) market confusion;
- (2) commercial bribery;
- (3) monopoly;
- (4) false propaganda;
- (5) infringement of trade secrets;
- (6) improper premium offering; and
- (7) slander in the market.

Sometimes, in judicial practice, it is difficult to distinguish between accepting bribes and attempts to gain a monopoly. Promotional activities (such as giving a gift with a sale) can have the appearance of offering a bribe.

¶100-035] Key Characteristic of Commercial Bribery

The key characteristic of commercial bribery is to obtain business opportunities through illegal means, to eliminate fair competition by other competitors, and to thwart fair competition in the market.

Key Characteristic of Commercial Bribe Offering

The key characteristic of bribing is to obtain competitive advantage over other competitors through means prohibited by law, to exclude other competitors and to obtain business advantage.

Business operators that obtain business opportunities through legal means, such as offering discounts or minimal profit through quick turnover, are permitted by law. However, providing discounts under false pretences is prohibited.

In judicial practice, the determination of bribing depends on various elements, including, but not limited to, the recipient and the purpose for the payment or incentive.

Key Characteristic of Accepting Commercial Bribe

(1) *The bribee is in a dominant position and plays a decisive role in facilitating the deal*

Usually, the bribee is in a dominant position, capable of insuring the business opportunity for the briber, and eliminating other competitors by virtue of its power or position. This is the most important characteristic of the bribee, and also a key factor in bribing, since offering and accepting bribes are interdependent.

For example, a manufacturer agrees to return a certain proportion of profit or a certain number of products to its distributor as long as the sales figure of the distributor meets certain standards provided in their agreement. Where the distributor is a sole agent, the return of profits and products is a normal means of promotion and incentive. Even if the distributor boosts its sales of the products for the purpose of getting the rewards, it is still in line with the marketing rules. In fact, the rewards to the distributor do not impact fair competition of competing products. On the other hand, if the distributor also serves other competitors, further investigation would be required to see whether the distributor boosted the sales of the products for the purpose of getting the rewards and whether the rewards to the distributor caused a sales advantage to those products over other competing products. If so, commercial bribery might be an issue.

(2) *The bribee is subordinate to and has an exclusive agency relationship with the briber*

This is one important standard distinguishing commercial bribery from legitimate marketing promotion.

For example, the sales representatives of a wine company sent to hotels for marketing can receive a reward from the wine company based upon collected cork's or caps. The reward offered by the wine company to these sales representatives does not constitute commercial bribery because the sales representatives are employed by the wine company, creating a subordinate relationship. The reward is actually part of their salary and an incentive for sales performance.

¶100-040] Tips for Practice

Considering the slow implementation of legislation and the fact that the Administrations for Industry and Commerce in different areas may have different understanding of the substance of commercial bribery, business operators should pay attention to the following issues when handling commercial bribery investigations:

(1) Wrongfully taking other unfair competition activities as commercial bribery

Commercial bribery is only one kind of unfair competition. Sometimes, monopoly is wrongfully construed as asking for a bribe, and an promotional offering is wrongfully taken as a bribe. In these scenarios, multinational corporations should analyse the situation reasonably and develop reasonable defences.

(2) Wrongfully taking legitimate business activities as commercial bribery

Discount and commissions are permitted by law. However, business operators should pay attention to the following when carrying out legitimate business activities:

- a. when carrying out lawful marketing and sales activities, make truthful accounting records in strict compliance with the applicable accounting standards; and
- b. cautiously select your business partners, conduct requisite due diligence against potential business partners, and urge them to make truthful accounting records. Where necessary, sign an anti-commercial bribery agreement with your potential business partners.

CHAPTER 5 HOT ISSUES OF ANTI-COMMERCIAL BRIBERY

Various Forms of Commercial Bribery in Practice	¶500-000
Offering Cash, Gift Certificates / Cards	¶500-005
Gifts.....	¶500-045
Kickbacks	¶500-080
Fake Donations	¶500-110
Commercial Sponsorships	¶500-135
Meals and Entertainment	¶500-155
Training and Travel.....	¶500-175
Third-party Payments.....	¶500-195
Other Forms of Commercial Bribery	¶500-215

¶500-000] Various Forms of Commercial Bribery in Practice

It is common for enterprises to incur promotion fees, publicity fees, sponsorship fees, scientific research fees, consultation fees and commissions, etc. in their business activities. Under what circumstances are these fees legitimate? When might they fall within the scope of commercial bribery? Is property donation always legal? Is it proper to provide sponsorship to customers? What kind of gift policy complies with Chinese laws and regulations? When will discounts be deemed to be kickbacks? These are the questions confronting senior management in multinational corporations, legal counsel in compliance departments and commercial managers.

In practice, multinational corporations are mainly faced with administrative investigations initiated by the Administration for Industry and Commerce. This chapter will address some hot issues around these administrative investigations. If commercial bribery acts reach the threshold of criminal punishment, those companies may bear the corresponding criminal liability.

Offering Cash, Gift Certificates / Cards

Offering Cash to the Transaction Counterparty or Any Party Who Can Influence the Transaction Being the Typical Form of Commercial Bribery

of Commercial Bribery.....	¶500-005
Relevant Laws and Regulations.....	¶500-010
Common Practices and Legal Analysis.....	¶500-015
Case Analysis.....	¶500-035
Practical Guidelines.....	¶500-040

¶500-005] Offering Cash to the Transaction Counterparty or Any Party Who Can Influence the Transaction Being the Typical Form of Commercial Bribery

The PRC *Anti-unfair Competition Law* and the *Interim Provisions on Prohibition of Commercial Bribery* expressly prohibit business operators from conducting commercial bribery by offering cash to the other party in a transaction or individuals at that entity in order to sell or purchase commodities. Other than directly offering cash to the bribee, offering prepaid cards, including stored value cards / certificates and shopping cards / certificates, is also considered to be the same as offering “cash”. In practice, offering cash to the transaction counterparty or any party who can influence the transaction is the typical form of commercial bribery. The Administration for Industry and Commerce is very sensitive about this practice and has paid great attention to it. As such, offering cash is very likely to be defined as commercial bribery and to be punished by the Administration for Industry and Commerce.

¶500-010] Relevant Laws and Regulations

The laws and regulations ruling such practice are mainly as follows:

- (1) Article 8 of the *Anti-unfair Competition Law* provides that: “business operators shall not use property or other methods to bribe others in order to sell or purchase commodities. A business operator who offers off-the-book kickbacks in secret to another entity or individual shall be guilty of offering a bribe and punished accordingly. Any entity or individual that accepts off-the-book kickbacks shall be guilty of accepting a bribe and punished accordingly. When selling or purchasing commodities, a business operator may expressly offer discounts to the other party or offer commissions to the intermediary. The discounts or the commissions offered or accepted by any business operators must be accurately recorded in the accounts book.”
- (2) Article 2 of the *Interim Provisions on Prohibition of Commercial Bribery* provides that “business operators shall not sell or purchase commodities by means of commercial bribery, in violation of the provisions of Article 8 of the *Anti-unfair Competition Law*.

For the purpose of these Provisions, commercial bribery refers to a business operator’s bribery to another entity or individual with property or by other means in order to sell or purchase commodities.

The term “property” mentioned in the preceding paragraph refers to cash and physical objects, including property given by a business operator to another entity or individual in the name of promotion fee, publicity fee, sponsorship fee, scientific research fee, labour service fee, consultation fee, commissions, reimbursement expenses, etc. in order to sell or purchase commodities. The term “other means” as mentioned in paragraph 2 hereof refers to any means other than giving property, such as offering domestic or international tours or field study in various names.”

- (3) The *Reply of the State Administration for Industry and Commerce on the Characterisation and Handling of Issues concerning Promoting Beers by Buying Back Beer Bottle Caps (Gong Shang Gong Zi [1997]) No. 321* provides that: “by

paying cash to the waiters of the hotels to collect beer bottle caps, the beer company was actually inducing the waiters to promote beers to the customers. The business operator, ie the beer company, was offering bribe by way of giving property to people who can have a direct influence over the sales of the commodities to increase the sales amount. Such practice, to some extent, pushed aside other business operators, restricted the customers' right of choice, harmed the customers' legitimate rights and interests and caused disorder to market competition. Therefore, such practice constituted commercial bribery, which is provided in Article 8 of the *Anti-unfair Competition Law* and Article 2 of the *Interim Provisions on Prohibition of Commercial Bribery* issued by the State Administration for Industry and Commerce and should be punished pursuant to *the law*."

- (4) The *Opinions on Appropriately Deciding the Boundaries of the Policy in the Specific Rectification of Commercial Bribery* issued by the Leading Group Office of the Central Government on Anti-commercial Bribery (*Zhong Zhi Hui Fa* [2007] No.4) provides that: "... receiving and accepting any kind of membership cards, stored value cards / certificates, shopping cards / certificates ... during the business operations ... constitutes commercial bribery."
- (5) The *Notice of the Supervision Department of the People's Bank of China Regarding the Opinions on the Regulation of Commercial Prepaid Cards* circulated by the General Office of the State Council (*Guo Fa Ban* [2011] No. 25) provides that: "it is strictly prohibited for any state functionaries, especially the leading cadres, to accept any commercial prepaid cards in any form during official works. Receiving commercial prepaid cards without turning over such cards promptly pursuant to the provisions will be considered as receiving bribe in the same amount as the value of the cards."

Common Practices and Legal Analysis

The Nature of Some Business Activities that Might be Very

Common and Standard Practice for the Majority of Operators in an Industry may Fall within the Scope of Commercial Bribery.....	¶500-015
Offering Shopping Cards.....	¶500-020
Offering Cash to a Transaction Counterparty through Sales Personnel.....	¶500-025
Promotion Fees.....	¶500-030

¶500-015] The Nature of Some Business Activities that Might be Very Common and Standard Practice for the Majority of Operators in an Industry may Fall within the Scope of Commercial Bribery

Offering a cash bribe is obviously illegitimate. Some other business activities might be very common and might even be standard practice for the majority of operators in an

industry. However, the nature of such activities or practices can still fall within the scope of commercial bribery and this creates an extremely risky operating environment. Some business operators may make payments in the name of reimbursement fees, labour service fees, consultation fees and commissions, etc. so as to cover up commercial bribery. It is important to distinguish between legitimate service fees / commissions and commercial bribery. The following contents outline detailed analysis.

¶500-020] Offering Shopping Cards

China is known as a nation of courtesy and propriety and Chinese people traditionally give "red envelopes", which contain money, to relatives and friends during festivals. In recent years, an increasing number of business operators offer customers, especially their specific contact at a customer, store value cards or shopping cards issued by malls and supermarkets for these festivals.

The *Notice of the Supervision Department of the People's Bank of China Regarding the Opinions on the Regulation of Commercial Prepaid Cards* circulated by the General Office of the State Council (*Guo Fa Ban* [2011] No. 25), provides that: "it is strictly prohibited for any state functionaries, especially the leading cadres, to accept any commercial prepaid cards in any form during official works. Receiving commercial prepaid cards without turning over such cards promptly pursuant to the provisions will be considered as receiving bribe in the same amount as the value of the cards."

According to the above-mentioned provisions, if a state functionary receives commercial prepaid cards but does not turn over such cards promptly pursuant to the provisions, this will be considered as receiving a bribe in the same amount as the value of the cards.

The Administration for Industry and Commerce will make reference to the provisions of the above-mentioned laws when dealing with cases in which persons who are not state functionaries receive commercial prepaid cards.

In this way, offering commercial prepaid cards to obtain business opportunities or favourable business conditions allegedly constitutes commercial bribery.

¶500-025] Offering Cash to a Transaction Counterparty through Sales Personnel

Offering incentives to motivate sales personnel is permitted. However, in order to approach customers and obtain business opportunities, some companies will prepay or reimburse the sales cost or sales incentives to the sales personnel of the companies in cash and the sales personnel will then offer the cash to the end customer or the key contact at that company under the pretext of another payment.

Both the company and the sales personnel are aware of the "underlying rules" and such payments will commonly be recorded as "sales costs" or "sales incentives" in the accounts book or financial book. Therefore, such payments are well concealed. However, for these sorts of "incentive, bonus and reimbursement fees", the administrative and enforcement agency will not only review the company's accounts book but also inspect the written report, emails and other records regarding the contents of such fees, as well as

interview relevant sales personnel. At the end of a comprehensive investigation, the agency will be able to track the payments and discover their true purpose.

On the surface, it might look like the company is only paying cash to the sales personnel as a certain percentage of sales incentives / bonuses in accordance with the sales volume reached by the sales personnel; in fact, such sales incentives / bonuses include the bribe paid by the sales personnel to a transaction counterparty.

¶500-030] Promotion Fees

According to the *Administrative Measures for Fair Transactions between Retailers and Suppliers*, retailers can charge suppliers a promotion fee if there is a contract and if the retailers have offered genuine promotion services. Some companies pay promotion fees to promoters for the promotion service provided. Such promotion fees may be fixed or calculated according to the sales volume. The payment of such fees can be genuinely based on the service provided, but sometimes companies are actually paying a bribe to the purchaser companies or the relevant people in those companies through the promoters in the name of promotion fee. Whether such practice allegedly constitutes commercial bribery depends on a case-by-case analysis and all the surrounding circumstances.

¶500-035] Case Analysis

Case Background

For business development purposes, sales personnel at the Changsha branch of a US company manufacturing pumps offered gifts or cash to key contact people at potential customers, with the implied consent of the General Manager and under the pretext of other payments. Once the branch reached the point of contracting with the customers, the sales personnel listed the cost of items that were necessary to “obtain the contract” and requested for the General Manager’s approval. Then the branch would reimburse the cost to the sales personnel and record such payments as “sales incentives” in the accounts book.

Legal Analysis

In this way, it looked as if the branch did not bribe under its own name. However, this practice can still fall under the scope of typical kind of commercial bribery.

Accused companies usually argued that the bribe was paid by the employee himself / herself and that the company should not be responsible for the employee’s personal activities. However, from the perspective of the administrative enforcement authorities, there are mainly three standards to decide whether commercial bribery can be attributed to the company’s action:

- (1) Did the employee approach the bribee to perform his/her work or to develop a personal friendship?
- (2) Will the bribery bring benefit to the company or the employee himself/herself?
- (3) Is the bribery decided by the company/the management of the company or the employee himself/herself? Other than expressly directing or requesting its

employees to conduct commercial bribery, the company’s awareness of its employees’ activities and the company’s implied consent will also be included as the company’s decision.

By these standards, it is not difficult for a law enforcement agency to conclude that a business operator offering benefits through employees to a transaction counterparty is actually commercial bribery conducted by the business operator. Business operators should not take any chances.

¶500-040] Practical Guidelines

In ordinary business operations, it is extremely risky to directly offer cash or cash coupons to a transaction counterparty or any party who can influence the transaction in some way. Such activities bring significant commercial bribery risks and business operators should be strictly prohibited by internal policies.

In practice, it can be difficult and controversial to distinguish lawfully-paid commissions to distributors from commercial bribery. These days, offering cash as an incentive directly to distributors by business operators is likely to be determined as commercial bribery by law enforcement agencies. To avoid the risk of legitimate business activities of a company being wrongfully determined as commercial bribery, there are several steps a company can take:

- (1) the company should conclude a written contract, which provides the detailed content of the genuine transaction with the distributor;
- (2) the company should be aware of preserving the written evidence corroborating its actual performance of this commercial contract, such as the commercial appraisal reports submitted by the distributor or the advertising materials made by the distributor to promote the sales of products, etc.; and
- (3) the company should accurately record the relevant payments under this contract in the accounts book and should not directly make any payments to employees of the distributor or any third party.

Gifts

“Whether Giving Gifts Constitutes Commercial Bribery”

Raises Significant Concerns for Companies in Practice.....	¶500-045
Relevant Laws and Regulations.....	¶500-050
Common Practices and Legal Analysis.....	¶500-055
Practical Guideline	¶500-075

¶500-045] “Whether Giving Gifts Constitutes Commercial Bribery” Raises Significant Concerns for Companies in Practice

When selling commodities or providing services, does the conditional giving of a certain number of gifts constitute commercial bribery? When visiting clients or attending meetings or when organising or participating in meetings or training, does the giving of gifts to transaction parties, to individuals, or to government officials constitute commercial bribery? Are courtesy gifts during cultural festivals compliant with the provisions of the laws? These sorts of questions raise significant concerns for companies in their business operations.

¶500-050] Relevant Laws and Regulations

The relevant laws and administrative regulations on gift giving are mainly as follows:

- (1) Article 8 of the *Anti-unfair Competition Law* provides that: “business operators shall not use property or other methods to bribe others in order to sell or purchase commodities. A business operator who offers off-the-book kickbacks in secret to another entity or individual shall be guilty of offering a bribe and punished accordingly. Any entity or individual that accepts off-the-book kickbacks shall be guilty of accepting a bribe and punished accordingly. When selling or purchasing commodities, a business operator may expressly offer discounts to the other party or offer commissions to the intermediary. The discounts or the commissions offered or accepted by any business operators must be accurately recorded in the accounts book.”
- (2) Article 8 of the *Interim Provisions on Prohibition of Commercial Bribery* provides that: “business operators shall not give any cash or property as a gift to another entity or individual during a commodity transaction, except for commonly offered promotional gifts with minimal value. Violation of the provisions of the preceding paragraph will be regarded as commercial bribery.”
- (3) Article 10 of the *Notice of the Supreme People’s Court and the Supreme People’s Procuratorate on Issuing the Opinions on Several Issues Concerning the Application of Law in Handling Criminal Cases of Commercial Briberies (Fa Fa [2008] No.33)* provides that: “in handling criminal cases of commercial briberies, the Supreme People’s Court and the Supreme People’s Procuratorate shall take into account the following factors: (1) background for the property transaction, such as whether the two parties are related or are friends, and the status and extent of their previous relationships; (2) values of the transacted property; (3) cause, time, and method of the property transaction, and whether the giver requested a position-related favour from the receiver; and (4) whether the receiver has taken advantage of his/her position for the giver’s benefit.”
- (4) Article 2 of the *Provisions on Registration of Gifts Received by Members of Communist Party and State Functionaries during Domestic Social Activities* issued by the General Office of the Central Committee of the Communist Party of China and General Office of the State Council (promulgated on 30 April 1995, came into effect from the date of promulgation) provides that: “for domestic social activities,

members of the CPC and state functionaries cannot receive any gifts which may influence their impartial exercise of official functions. Gifts that cannot be turned down for various reasons must be registered and turned over. Other gifts received by members of the CPC and state functionaries during domestic social activities (except for social activities between friends and relatives) over a certain minimum value must be registered.”

- (5) Article 3 of the *Measures on Registration and Handling of Gifts Received by State Functionaries of the Central Party during Domestic Social Activities* issued by the Administrative Bureau of Institutions directly under the Central Committee of the CPC and the Administrative Bureau of Institutional Affairs of State Council ([95] Guo Guan Cai Zi No. 158), provides that: “in terms of gifts that cannot be turned down for various reasons and that are received by state functionaries of the Central Party in domestic social activities (except for social activities between friends and relatives), gifts with a total market value of more than RMB100 (including RMB100) must be registered; while gifts with a total market value of more than RMB200 (including RMB200) must be registered and turned over. If a state functionary receives gifts with an accumulative value of more than RMB600 within one year, the portion over RMB600 must be registered and turned over.”
- (6) Article 7 of the *Regulation of State Council on Giving and Receiving Gifts in External Official Activities* (State Council Order No. 133) provides that: “gifts received during external official activities shall be properly disposed of. The recipient shall fill in a form declaring any gift received in China with a market value of more than RMB200 within one month from the date of receipt (or from the date of return to China if the gift is received abroad), and turn over the gifts to be turned over to the gift administrative authorities or the government entity where the recipient is located. A gift worth less than RMB200 can be kept by the recipient or by the government entity where the recipient is located. Cash and negotiable instruments offered by a foreign party during external official activities must be declined; where there is genuine difficulty to decline, the cash and negotiable instruments must be turned over to the State Treasury.”
- (7) The *Eight Rules on Improving Working Ethics and Fortifying Relationship with the General Public* and the *Six Bans on Improving Working Ethics and Fortifying Relationship with the General Public* issued by the Political Bureau of the Central Committee of the CPC in 2013.

Common Practices and Legal Analysis

Cultural Courtesy Gifts.....	¶500-055
Promotional Gift Giving.....	¶500-060
Advertising Gift of Minimal Value.....	¶500-065
Miscellaneous.....	¶500-070

CHAPTER 8 ADMINISTRATIVE INVESTIGATIONS INTO COMMERCIAL BRIBERY AND STRATEGIES FOR COOPERATION IN THESE INVESTIGATIONS

Characteristics of Administrative Penalties on Commercial Bribery.....	¶800-000
General Introduction of Administrative Investigations into Commercial Bribery.....	¶800-005
Methods of Conducting an Administrative Investigation into Commercial Bribery.....	¶800-045
Concluding an Administration Investigation into Commercial Bribery.....	¶800-135
How to Cooperate in an Administrative Investigation into Commercial Bribery.....	¶800-190

[¶800-000] Characteristics of Administrative Penalties on Commercial Bribery

In comparison with the criminal penalties, administrative penalties on commercial bribery have the following characteristics:

- (1) Administrative penalties are the main measures for dealing with commercial bribery.

As PRC laws do not stipulate the “threshold” for administrative penalties on commercial bribery, the threshold for these penalties is comparatively low. In practice, the measures against most bribes in the commercial area are administrative penalties rather than criminal penalties, even if the relevant illegal activities have already satisfied the statutory elements for constitution of an offence.

- (2) The administrative enforcement authorities for commercial bribery target bribers in commercial bribery.

This is different from criminal enforcement authorities, which mainly focus on bribees. However, in practice, bribees in commercial bribery may also be subject to administrative penalties.

- (3) Administrative penalties for commercial bribery are only imposed on business operators.

Administrative penalties are different in scope from criminal penalties. Administrative penalties generally will not be against individuals, that is, administrative penalties generally will not be imposed on the specific persons who conducted the commercial bribery, persons-in-charge of enterprises, or the legal representatives of enterprises.

Due to the nature of administrative penalties, a multinational corporation is inevitably involved in administrative investigations of commercial bribery during daily operation. This chapter aims at introducing the basic procedures of these administrative investigations,

such as the launch, modes and termination, to answer the common problems business operators face during administrative investigations and to give guidance on how a multinational corporation shall cooperate with administrative investigations.

General Introduction of Administrative Investigations into Commercial Bribery

Relevant Basic Laws and Regulations of Administrative Investigations into Commercial Bribery.....	¶800-005
Authorities Responsible for Administrative Investigations into Commercial Bribery.....	¶800-010
Determination of Jurisdiction over Administrative Investigations into Commercial Bribery.....	¶800-015
General Procedures of Administrative Investigations into Commercial Bribery.....	¶800-020
Reasons for Administration for Industry and Commerce to Launch Administrative Investigations into Commercial Bribery.....	¶800-025

[¶800-005] Relevant Basic Laws and Regulations of Administrative Investigations into Commercial Bribery

The *PRC Anti-unfair Competition Law* is the basic law used for commercial bribery in China, which explicitly states that commercial bribery conducted by business operators shall be subject to administrative penalties.

The *Provisional Regulations on Prohibition of Commercial Bribery* further stipulate that “in addition to administrative penalties on business operators for the bribe offering, the administrative enforcement authorities shall also have the right to investigate and handle bribe accepting and to impose administrative penalties on the bribee when conducting supervision and inspection of commercial bribery”.

China has not yet formulated specific regulations for administrative investigations into commercial bribery. When launching administrative investigations into commercial bribery, law enforcement authorities mainly depend on the *Law of the People’s Republic of China on Administrative Punishments* and the rules of the supporting department promulgated by the State Administration for Industry and Commerce, which mainly include the *Provisions of Administration for Industry and Commerce on the Procedures for Administrative Punishments*, the *Rules of Administration for Industry and Commerce on Hearing of Administrative Punishment Cases*, and the *Measures of Administration for Industry and Commerce on Determination of Illegal Incomes of Administrative Punishment Cases*.

¶800-010 Authorities Responsible for Administrative Investigations into Commercial Bribery

Administration for Industry and Commerce

The *PRC Anti-unfair Competition Law* stipulates that unless the laws and regulations provide otherwise, the inspection and supervision of investigations into acts of unfair competition shall be done by the administrations for industry and commerce of the people's governments at the county level or above. As commercial bribery is a typical example of unfair competition, administrative investigations into commercial bribery shall be done by the local administrations for industry and commerce. In practice, fair trade offices of all levels of the Administration for Industry and Commerce specialise in administrative investigations into commercial bribery.

Other Authorities Responsible for Administrative Investigations into Commercial Bribery

In specific industries, administrative investigations into commercial bribery will also involve other investigation authorities such as:

(1) Insurance Regulatory Authorities

According to the *Reply of China Insurance Regulatory Commission on Clarifying Law Enforcement on Acts of Unfair Competition by an Insurance Agency*, the insurance regulatory authorities shall have the right to supervise and regulate unfair competition (including commercial bribery) in the insurance industry pursuant to the law and, if necessary, may ask the local Administration for Industry and Commerce to cooperate.

(2) Banking Regulatory Authorities

There is a disagreement between the China Banking Regulatory Commission and the Administration for Industry and Commerce on the jurisdiction of banking financial institutions over acts of unfair competition.

According to the *Reply of General Office of China Banking Regulatory Commission on Issues Relating to Unfair Competition by Banking Financial Institutions*, the China Banking Regulatory Commission and its affiliated institutions shall be in charge of investigating and imposing penalties on acts of unfair competition involving banking financial institutions.

The *Reply of Fair Trade Bureaus of the State Administration for Industry and Commerce concerning Request for Instructions on Jurisdictional Issues Arising in Unfair Competition by Financial Enterprises such as Commercial Banks* provides that except for acts of unfair competition that are investigated and punished by the banking regulatory authorities as expressly specified in *Commercial Bank Law*, the Administration for Industry and Commerce shall have the right to supervise and inspect other acts of unfair competition that restrict competition (including commercial bribery).

This regulation, to some extent, clarifies the jurisdictional issues between the Administration for Industry and Commerce and the banking regulatory authorities and confirms the supervision and inspection right of the banking regulatory authorities in specific instances of commercial bribery.

Example: Article 74(3) of the *Commercial Bank Law* provides that if commercial banks violate the provisions by increasing or decreasing the interest rate in any way, or by using other improper means to collect deposits and extend loans, the banking regulatory authorities may impose administrative penalties on the commercial banks. Thus, the banking regulatory authorities shall have the right to oversee investigations of commercial bribery based on collection of deposits and extension of loans.

It shall be noted that, because commercial bribery may also be a crime, the Administration for Industry and Commerce will sometimes conduct joint administrative investigations into commercial bribery with the public security authorities. In practice, it is very common to see joint investigations on a nationwide campaign cracking down on commercial bribery. The Administration for Industry and Commerce and public security authorities will launch joint investigations into commercial bribery that are led and organised by local governments.

¶800-015 Determination of Jurisdiction over Administrative Investigations into Commercial Bribery

(1) Territorial jurisdiction in administrative investigations into commercial bribery

Under Chinese law, territorial jurisdiction systems are implemented mainly for jurisdiction over administrative illegal acts, that is, administrative authorities at the county level or above that may impose administrative penalties will have jurisdiction over commercial bribery at the place of occurrence of the illegal acts. The Administration for Industry and Commerce has jurisdiction over the commercial bribery activities that occur within its area.

In practice, due to practical issues surrounding investigation and evidence collection, the Administration for Industry and Commerce will consider whether there are connecting factors between the parties concerned, such as whether the parties concerned actually operate or have established representative offices within the relevant area, when deciding on jurisdiction.

(2) Exceptions to territorial jurisdiction under special circumstances

Apart from the above-mentioned basic principles, as the Administration for Industry and Commerce has the right to investigate both acts of bribe offering and bribe accepting, the Administration for Industry and Commerce can extend its jurisdiction beyond normal territorial limits under special circumstances.

If a bribee's registered or business address is within an Administration for Industry and Commerce's administration area while the briber is not within its administration area, the Administration for Industry and Commerce may launch an administrative investigation

into commercial bribery against the briber as well as the bribee and impose punishment on both parties, even though the briber is beyond the limits of its jurisdiction.

(3) Determination of jurisdiction in cases of conflicts of jurisdiction

According to the principles of determination of jurisdiction, it is possible that two or more branches of an Administration for Industry and Commerce may have jurisdiction over the same parties' commercial bribery.

According to the *Provisions of Administration for Industry and Commerce on the Procedures for Administrative Punishments*:

- a. When two or more Administration for Industry and Commerce branches have jurisdiction over the same violation by the same party, the Administration for Industry and Commerce that files the case first shall have proper jurisdiction; and
- b. When there is a dispute over jurisdiction between two or more Administration for Industry and Commerce branches, the dispute shall be resolved through consultation. If consultation fails, the Administration for Industry and Commerce shall report the dispute to a common higher-level Administration for Industry and Commerce for resolution.

In other words, if Shanghai Pudong Administration for Industry and Commerce and Beijing Xicheng Administration for Industry and Commerce both claim to have jurisdiction over the same instance of commercial bribery and they cannot resolve the dispute over jurisdiction through consultation, they shall report the conflict to the State Administration for Industry and Commerce for resolution.

(4) Company A has several branches and all the branches adopt the same business model. If the Administration for Industry and Commerce in location B determines the business model to be a form of commercial bribery, how will this affect the branches within the administration area of other Administrations for Industry and Commerce?

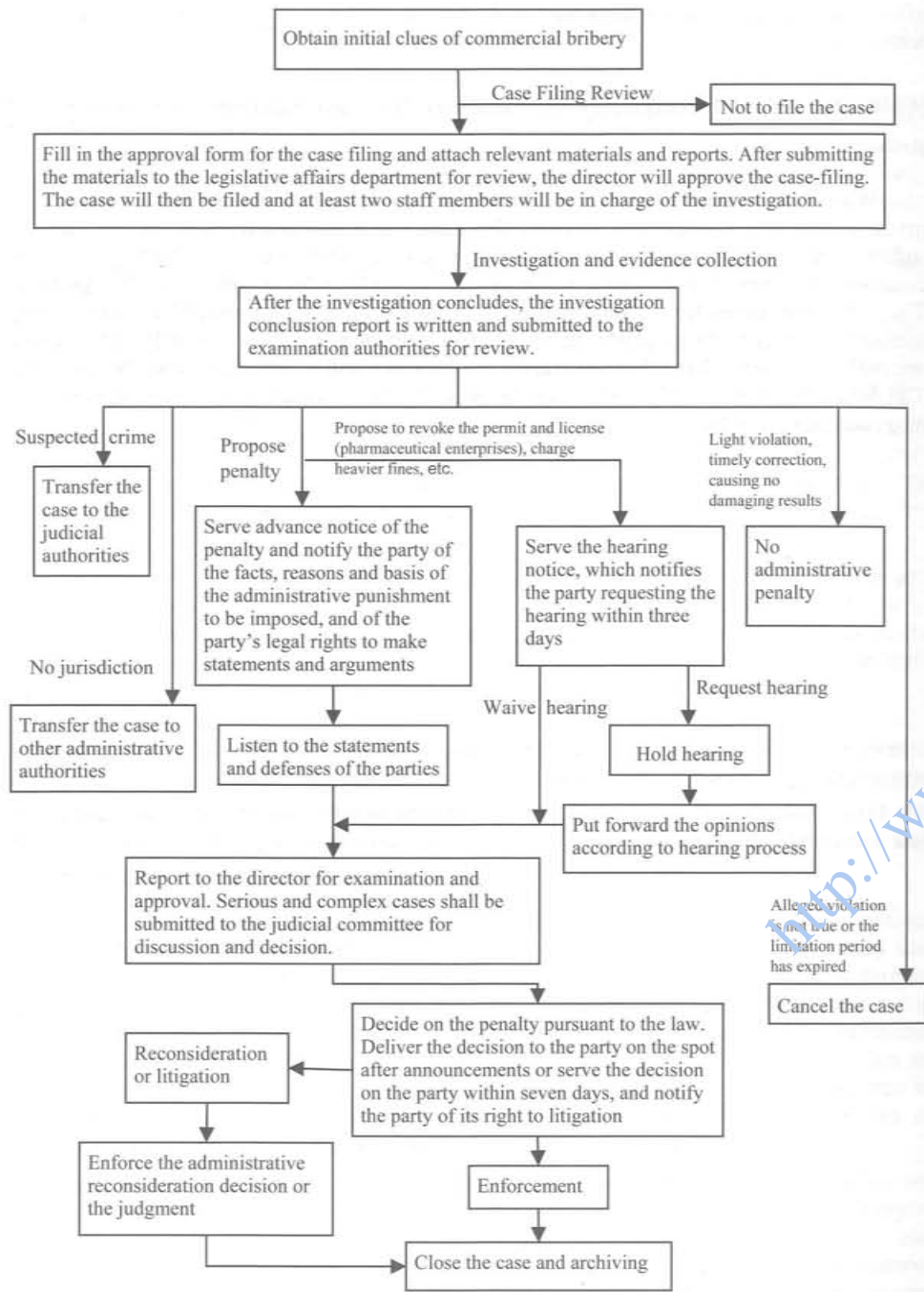
As stated above, the basic principle of jurisdiction in administrative investigations into commercial bribery is territorial jurisdiction. The Administration for Industry and Commerce will usually only investigate acts of commercial bribery occurring within its territory. Based on this principle, even if the Administration for Industry and Commerce in location B determines that the business model of Company A constitutes commercial bribery and imposes administrative penalties on the branches of Company A within its jurisdiction, this does not mean that the Administration for Industry and Commerce in location B has the right to directly impose administrative penalties on branches of Company A that are outside its territory for the same or similar acts.

Of course, if other branches of Administration for Industry and Commerce are informed that some branches of Company A are likely to commit commercial bribery in their jurisdiction, they would probably launch administrative investigations into commercial bribery. In these cases, the verified facts and reasons for punishment developed by the Administration for Industry and Commerce in location B will probably

affect the investigations of other branches of Administration for Industry and Commerce to some extent.

[¶800-020] General Procedures of Administrative Investigations into Commercial Bribery

When the Administration for Industry and Commerce launches an administrative investigation into commercial bribery, the main basis for enforcement is the *Law on Administrative Punishments*. The procedures for an administrative investigation into commercial bribery are the same as the general procedures for an administrative penalty. Thus, the procedures for an administrative investigation into commercial bribery mainly include case filing, investigation and evidence collection, examination and approval (the internal procedures of the Administration for Industry and Commerce), and the decision. The following is a brief flow chart of the procedures for an administrative investigation into commercial bribery:



Reasons for Administration for Industry and Commerce to Launch Administrative Investigations into Commercial Bribery

Means of Discovering Commercial Bribery ¶800-025
 Discovering Commercial Bribery through Routine Inspections ¶800-030
 Discovering Commercial Bribery through Insiders' Reports ¶800-035
 Conducting an Investigation after Receiving Evidence from the Bribee ¶800-040

¶800-025] Means of Discovering Commercial Bribery

The Administration for Industry and Commerce will officially launch an administrative investigation into commercial bribery by filing the case only after finding out the basic facts of commercial bribery first. In theory, the Administration for Industry and Commerce can uncover commercial bribery through direct supervision, inspection, complaints, appeals, reports, any other authorities transferring the case, or any higher-level authorities who assigned the case.

¶800-030] Discovering Commercial Bribery through Routine Inspections

In an administrative investigation into commercial bribery, the Administration for Industry and Commerce conducted a routine inspection on Company A and randomly browsed through Company A's financial books. Unfortunately, the Administration for Industry and Commerce uncovered some reimbursements for entertaining clients and client gifts. The Administration for Industry and Commerce then requested Company A to provide other relevant financial books for review. This request does not constitute evidence collection, but rather routine inspection because the request of the Administration for Industry and Commerce was not specifically aimed at particular counterparties and transactions. The Administration for Industry and Commerce ultimately uncovered the facts of commercial bribery by reviewing the financial books of Company A, and officially launched an administrative investigation into commercial bribery.

Under existing laws, as the competent authority to investigate commercial bribery, the Administration for Industry and Commerce is responsible for the supervision and inspection of commercial bribery of enterprises and policing them for commercial bribery. To perform these duties, the State Administration for Industry and Commerce requires all levels of the Administration for Industry and Commerce to conduct regular and special inspections. Therefore, both supervision and routine inspections are part of the daily work of the Administration for Industry and Commerce. These routine inspections uncover many instances of commercial bribery.

¶800-035] Discovering Commercial Bribery through Insiders' Reports

During an administrative investigation into commercial bribery, the Administration for Industry and Commerce unexpectedly decided to launch an investigation into

CHAPTER 10 COMPLIANCE RISKS FOR OVERSEAS CHINESE COMPANIES

Common Compliance Issues for US-listed Chinese

Companies.....	¶1000-000
Risks and Challenges for Chinese Companies.....	¶1000-005
Triggers for Anti-bribery Investigations.....	¶1000-030
Investigations Directed by the Audit Committee	¶1000-045
Conducting an Anti-bribery Internal Investigation.....	¶1000-075
Reporting.....	¶1000-100
Possible Consequences of an Internal Investigation	¶1000-110

[¶1000-000] Common Compliance Issues for US-listed Chinese Companies

In recent years, US-listed Chinese companies have faced a host of legal compliance issues. This chapter aims to help Chinese companies address some of these issues. First, it introduces various anti-bribery issues that US-listed Chinese companies may encounter in their commercial transactions. It then discusses the penalties that non-compliant US-listed Chinese companies may face under US law. Finally, it addresses how to properly conduct an internal investigation of alleged non-compliant behavior.

Risks and Challenges for Chinese Companies

Few Chinese Companies Fully Appreciate the Risks of

Becoming an Overseas-listed Company	¶1000-005
Accounting Risks and Challenges	¶1000-010
Related Party Disclosures	¶1000-025

[¶1000-005] Few Chinese Companies Fully Appreciate the Risks of Becoming an Overseas-listed Company

Few Chinese companies seeking to access capital markets overseas fully appreciate, in advance of listing, the risks associated with the endeavour. The fault mostly lies with bankers and lawyers who promote these deals and take percentages or stock at the time of listing with little concern for the year-after-year compliance requirements that will be imposed upon the listed company. According to our observation, few CEOs and CFOs know how to operate a listed company in a foreign capital market successfully.

Accounting Risks and Challenges

Accounting Challenges.....	¶1000-010
Accounting Transparency	¶1000-015
Accounts Books and Records Requirements	¶1000-020

[¶1000-010] Accounting Challenges

If a Chinese company subject to the FCPA fails to comply with US GAAP in accounting, there is a risk that it will violate the books and records provisions of the FCPA. Thus, it is necessary that these companies fully understand the accounting provisions under the FCPA.

US GAAP may differ from Chinese accounting standards. A major hurdle for Chinese companies is maintaining books which satisfy US GAAP under a PRC accounting regime.

The PRC tax accounting system may require that a company maintains and provides formal tax receipts for all transactions. Many companies are often reluctant to provide such receipts because it requires the company to recognise its actual revenue, or acknowledge the performance of work outside the company's statutory business scope. The US accounting system does not have the concept of receipts as US companies can justify cash payments and receipts through contracts, invoices, and other unofficial documents which are not sanctioned or monitored by the tax authorities, except to the extent that the annual audit of accounts of the company demonstrates whether the transactions are fully and accurately documented by the company.

Moreover, US companies' transactions are generally not constrained by their business scope. Business scopes are broadly defined with catch-all language that gives the company wide latitude in its business activities. As US companies are not constrained by these two limitations, US GAAP is easier to manage for a US company than for a Chinese company.

Through litigation and the performance of internal investigations, we have seen many Chinese companies encounter problems in the following accounting areas:

- (1) preparation of multiple sets of books by the company at the same time;
- (2) misleading accounting entries;
- (3) use of third parties for transactions; and
- (4) failure to implement efficient internal controls, eg chop policies or delegations of authority, to assure corporate control over company transactions.

These issues typically arise at year-end audit of the company and may be easily rectified, if promptly disclosed. Unfortunately, to avoid potential issues, many Chinese companies attempt to hide accounting deficiencies and aggravate the situation by failing to be candid with the auditors. Such lack of candor only increases the risk of sanctions and adverse consequences when the accounting practice in violation of regulations is discovered. The lack of information disclosure taints the activity with the patina of, at best, falsification of records and at worst, criminality. These issues can better be addressed as cultural and economic differences between China and the US. If such issues are addressed

head-on, the likelihood of adverse consequences, eg sanction and sacking of the CFO, can be averted.

¶1000-015 Accounting Transparency

For overseas and especially US-listed company purposes, a premium is placed on transparency in accounting records. Documentation of a transaction must be sufficient to fully and adequately describe the transaction, and the nature of the transaction should be identifiable from the record. For this reason, even the so-called “basket entries” in accounting can be construed as inappropriate under GAAP, eg “miscellaneous” or “other receivables”.

¶1000-020 Accounts Books and Records Requirements

To meet the preparation requirements for US accounts books and records, the company must monitor the books maintained, the manner in which they are maintained, the personnel responsible for maintaining the books, and the frequency of ad hoc review of the books. These requirements can give challenges to a company in China where the company may lack a centralised server for non-accounting records. Thus, even though the accounting server may adequately maintain the accounting records, it may not capture the true nature of the transactions or all of the company transactions.

¶1000-025 Related Party Disclosures

China has traditionally encouraged business with related parties. Familial traditions and relationships often meant that your most trusted trading partner would be your relative or close friend. In Western style business, parties believe in arm’s length transactions to ensure fair dealing. Almost the opposite is true in China.

The relevant law may make reference to Item 404(a) of Regulation S-K under the US Securities Act of 1933: a company must make disclosure regarding: (1) any transaction since the beginning of the company’s last fiscal year, or any currently proposed transaction; (2) transaction in which the company was or is to be a participant; (3) transaction in which the amount involved exceeds USD120,000; and (4) transaction in which any related party had or will have a direct or indirect material interest.

A related party refers to: (1) a director or executive director of the listed company; (2) any nominee for the director, when the information required by Item 404(a) of Regulation S-K is being presented in a proxy or information statement relating to the election of that nominee for the director; (3) an immediate family member of a director or senior management of the listed company; or of any nominee for the director when the information required by Item 404(a) of Regulation S-K is being presented in a proxy or information statement relating to the election of that nominee for the director; or (4) any beneficial owner with securities of more than 5% of any class of the company’s voting right or any immediate family member of such beneficial owner.

An immediate family member refers to any child, stepchild, parent, stepparent, spouse, sibling, mother-in-law, father-in-law, son-in-law, daughter-in-law, brother-in-law, or sister-in-law of such director, senior management or nominee for the director, and any

person (other than a tenant or employee) sharing the household of such director, senior management or nominee for the director.

According to the relevant regulations, relatives refer to: (1) only those persons who are currently related to the primary reporting person (eg a person who is divorced from a director’s daughter would no longer be required to report the transactions); and (2) only those persons who are related by blood or step relationship to the primary reporting person (eg the sister of a director’s spouse is considered as a sister-in-law for purposes of this item; the sister-in-law’s husband, however, is not considered as a brother-in-law for purposes of this item).

For information disclosure purposes, materiality of interest is determined on the basis of the significance of the information to investors in light of all the circumstances. Factors considered when determining materiality include: the relationship of the related persons to the transaction, and to each other, the importance of the interest to the person having the interest and the amount involved in the transaction. Disclosure is required within three years from the date of the transaction.

Also, there are special requirements for related party loans. Item 404(a) of the Regulation S-K requires disclosure of indebtedness to a related party by a company if there is a direct or indirect material interest in a transaction exceeding USD120,000. Loans to entities in which a related party has a material interest must be disclosed by the company. For example, disclosure is required if the CEO had a material indirect interest in a loan transaction exceeding USD120,000 between the company and another entity due to the CEO’s ownership interest in such entity. As mentioned below, there is no threshold for determining materiality. The interest would be material if, in light of all the relevant factors, the information is significant to the investor.

There are some exceptions to disclosure requirements. For example, loans to substantial shareholders (including beneficial owners with 5% or more of the shares) and loans made in the ordinary course of business are not required to be disclosed. There are also exceptions to disclosure requirements in relation to remuneration of the management.

In China, there are many reasons why a company may have related party transactions including but not limited to: establishing companies at the request of relatives for the purpose of sharing income, where the relative may be concerned that his/her identity as a shareholder would be problematic; trading with relatives; soft banking or grey market banking issues for short term funding needs. These activities, if they involved individuals deemed related parties for purposes of the US Securities and Exchange Commission, must be disclosed to shareholders. Again, we often see that it is not the related party transaction itself that proves a problem for the Chinese company, but rather, the failure of the company to disclose the transaction promptly.

Triggers for Anti-bribery Investigations

Competitors or Disgruntled Employees.....	¶1000-030
External Auditors	¶1000-035
Short Sellers	¶1000-040

¶1000-030] Competitors or Disgruntled Employees

In China, it is not uncommon for the competitors or disgruntled employees to attempt to gain advantage against the company by filing a formal or informal complaint. Employees may use such means to avoid termination and may further claim wrongful termination if they are fired after revealing certain non-compliance issues of the company. We see many cases where an underperforming employee, faced with the likelihood of termination before or after a poor annual review, suddenly sends an email or letter to the company's legal department, compliance officer, or members of the board of directors, raising concerns about internal business practices in violation of the regulations. Companies are charged with fully exploring these allegations and resolving them.

Similarly, we often encounter situations where a disgruntled competitor or a terminated distributor or agent may make allegations against the company, which again require formal investigation. Usually these allegations relate to improper kickbacks or bribes to obtain commercial benefits. Such allegations against a US-listed company are very damaging, require investigation, and may result in inquiry by the US Department of Justice as well as the US Securities and Exchange Commission. The US Department of Justice is concerned with whether the acts of the company amount to criminal offence. The US Department of Justice cooperates with the US Securities and Exchange Commission as the two bureaux often have overlapping investigatory work.

¶1000-035] External Auditors

External auditors often discover accounting irregularities during the audit and demand detailed explanations for the reasons behind any questionable accounting entries. Generally, companies are able to satisfy auditor inquiries to achieve completion of the year-end audit. Unfortunately, with the accounting scandals in the past few years, auditors have become increasingly conservative in their willingness to condone certain accounting practices or otherwise to sign off on the books and records of the company unless they have absolute confidence that no issues will arise. As a result, where companies cannot explain certain Chinese business practices to the satisfaction of the external auditor, the auditor may quit. If the auditor terminates the engagement, the auditor will often inform the audit committee in writing, highlighting those issues that remain unresolved during the audit and that warrant further evaluation by the audit committee. Depending upon the nature of the issues and the extent of such issues, the audit committee may elect to commence an internal investigation to further understand why the auditors terminated the engagement.

¶1000-040] Short Sellers

Beginning with the market downturn in the US, some investors began to see opportunities to make substantial sums in the market by short selling stock. Essentially, a broker lends stocks of a company to a short seller and a short seller will return such stock to the broker when it is due. Short seller benefits if the stock price dips. Thus, short sellers seeking to make a profit will use allegations of wrongdoing against a company as a means to manipulate stock price.

Chinese stocks listed in the US became short seller targets in late 2010 and throughout 2011. The short sellers made huge dividends on the transaction. For example, the owner of the short selling firm, Muddy Waters, claimed to have made millions of US dollars on the short sale of stock in Ontario-listed Sino Forest. It is noted that Muddy Waters and its CEO, Carson Block, have now been sued by Sino Forest in bankruptcy.

In most instances, claims arising by short sellers will be brought to the attention of the Audit Committee of the Board of Directors. The audit committee may elect to use internal resources to investigate or hire third parties to verify the allegations. Generally speaking, it is in the interests of the members of the audit committee to hire third parties to perform the investigation as this insulates these board members from civil liability for failing to adequately investigate such claims in the event of shareholder lawsuits.

Investigations Directed by the Audit Committee

Scope of Investigation	¶1000-045
Hiring Lawyers and Forensic Consultants	¶1000-050
Use of the Client Privilege	¶1000-055

¶1000-045] Scope of Investigation

The Audit Committee decides the scope of the investigation that will be undertaken. Usually, the scope of investigation will mirror the allegations. The Audit Committee generally allows the investigation team to expand the scope of investigation to any areas when additional compliance issues come to light as a result of the investigation review. In a large number of the cases we have handled involving Chinese companies listed in the US, internal review of issues raised by the auditors frequently uncovers additional FCPA issues. For example, off-the-books accounting is often detected by the auditors. A review of the off-the-books accounts usually identifies improper payments to third parties that the company is unable to book openly, for example, payment for gifts to officials at holidays.

¶1000-050] Hiring Lawyers and Forensic Consultants

Once the Audit Committee decides that an internal investigation is warranted for bribery issues and decides that the investigation should be performed by outside audit firms,

the Audit Committee must find appropriate audit firms to perform the work. In assessing which forensic consultant to hire, the Audit Committee should consider the following:

- nature of the investigation to be performed. Forensic accounting versus standard investigation work;
- comprehensive ability of the firm, location and size of the team;
- IT capability;
- prior investigation experience;
- Chinese language capability; and
- understanding of Chinese business and culture.

In assessing which law firm to hire, the Audit Committee should consider the following:

- location and size of the team;
- Chinese language capability;
- relations with the US Department of Justice and US Securities and Exchange Commission;
- prior investigation experience; and
- understanding of Chinese business and culture.

Investigations are very expensive undertakings and we recommend getting a budget in advance of the start of the work. To the extent possible, the Audit Committee should work to control costs while getting the most comprehensive review of the issues.

Use of the Client Privilege

Use of the US Attorney-client Privilege under the US Law	¶1000-055
What is the Privilege.....	¶1000-060
How is Privilege Used	¶1000-065
How is Privilege Created and Maintained	¶1000-070

[¶1000-055] Use of the US Attorney-client Privilege under the US Law

We usually recommend the investigation should mainly be conducted by a PRC law firm and engage a US law firm for the investigation at the same time. Engaging a PRC law firm will ensure that the investigation team understands the Chinese business and accounting standards properly. US law firms will have contacts with the US government, and will be in the same time zone to promptly respond to investigation inquiries. Meanwhile, US attorneys will provide the blanket protections afforded by the concepts of the “attorney-client privilege” and the “attorney work product privilege”.

[¶1000-060] What is the Privilege

In the United States, under the American Bar Association “Model Rules of Professional Conduct” (Rule 1.6) and under the bar rules of the individual states, the attorney is barred from disclosing the information of his/her client to third parties except in certain specific circumstances. Rule 1.6 of the “Model Rules of Professional Conduct” provides that:

- (1) A lawyer shall not reveal information relating to the representation of a client unless the client gives informed consent, the disclosure is impliedly authorised in order to carry out the representation or the disclosure is permitted by paragraph (2) below.
- (2) Under the following circumstances, a lawyer may reveal information relating to the representation of a client to the extent the lawyer reasonably believes necessary:
 - (a) to prevent reasonably certain death or substantial bodily harm;
 - (b) to prevent the client from committing a crime or fraud that is reasonably certain to result in significant damage to the economic interests or property of another person and in furtherance of which the client has used or is using the lawyer’s services;
 - (c) to prevent, mitigate or rectify significant damage to the economic interests or property of another person that is reasonably certain to result or have resulted from the client’s commission of a crime or fraud in furtherance of which the client has used the lawyer’s services;
 - (d) to secure legal advice about the lawyer’s compliance with these Rules;
 - (e) to establish a claim or defence on behalf of the lawyer in a controversy between the lawyer and the client, or to establish a defence to a criminal charge or civil claim against the lawyer based upon the conduct in which the client was involved, or to respond to allegations in any legal proceeding concerning the lawyer’s representation of the client; or
 - (f) to comply with other laws or a court order.

The above privilege also applies to any documents prepared by the attorney for the purpose of representing the client. This is known as the “attorney work product privilege”. In both instances, the general rule is that a lawyer shall not disclose his/her client’s information to a third party unless he/she must do so to stop the commission of a crime or fraud that may result in serious injury or death or as required by a court order. Thus, an attorney cannot, without the client’s consent, divulge to members of the US government, regulatory authorities, shareholders, listing exchanges or any third party, the information that has been obtained through the representation, which in this instance specifically relates to the work and the findings of the investigation. Even the method of investigating the allegations is considered privileged because it may reveal an attorney’s mental impressions or have been influenced by the attorney’s knowledge and information from the case.

[¶1000-065] How is Privilege Used

Often in these investigations, US regulatory authorities and shareholders generally want to know what is happening during an investigation. The privilege gives the attorney