

THE PRACTICE

Flow of Money Out of China Has Officials on Alert

Regulators are clamping down on transfers out of the country. Lawyers need to learn the new rules.

BY DAN WEBB AND ROBB C. ADKINS

Increasing fund-transfer activity out of China and recent changes in China's financial regulations have placed financial institutions and advisers doing business there under increased regulatory scrutiny, raising the specter of enforcement actions by China and even the United States.

In light of these developments, advisers of both local and foreign entities operating in mainland China and Hong Kong should ensure that they closely monitor the evolving regulatory and enforcement environment, and should reexamine their compliance and control policies.

Although moving money offshore is not a new trend in China, the sheer amount of cash reportedly moving abroad is striking. An internal government report released by the People's Bank of China claims that public officials, including executives at state-owned enterprises, have illicitly transferred more than \$120 billion out of China since the mid-1980s, and up to 18,000 corrupt officials

have fled abroad or gone into hiding since the mid-1990s.

There are also claims that many Chinese companies and individuals have used offshore entities to engage in illicit or illegal behavior.

REASONS FOR LARGE FUND TRANSFERS

It should be noted that a host of reasons exist—many completely lawful—for large fund transfers out of mainland China.

One incentive has its roots in China's economic reforms in the early 1990s, which reorganized China's economy and drove some Chinese business offshore because the laws were written with state-owned enterprises in mind, not entrepreneurs struggling to advance new technologies.

Additional economic factors include increased legitimate wealth among the Chinese population and a tax regime that

favors foreign investment.

Many fund transfers, however, are designed to manipulate or evade the Chinese rules and possibly launder illicit proceeds. For example, one reported practice that some Chinese manufacturers engage in is reducing their taxes through "round-trip" transactions—setting up subsidiaries outside the country, then selling their



products at low cost to the subsidiaries, thus allowing the parent companies to avoid taxes by showing little or no profits inside China. The offshore entities then resell the goods at a markup and funnel the profits back to the parents as untaxed “foreign investment.”

Another preferred method of moving illicit funds out of China involves the help of individuals living or emigrating abroad. Shell-company structures are often organized to open bank accounts in the offshore firm’s name, which helps to conceal the relationship to the real account owner. In early July, state broadcaster China Central Television reported that Bank of China, one of the Big Four state-owned banks in China, allegedly has been providing “money laundering services” to rich mainlanders to help them emigrate under the veil of an approved foreign-exchange program.

The China Central report was especially noteworthy in light of a June 19 directive issued by the State General Administration of Press, Publication, Radio, Film and Television, that banned media organizations from making “critical reports” against major government institutions without prior approval.

China has been taking steps in response to this reported conduct. For example, new rules now

require Chinese citizens to report their overseas assets, and individual foreign-currency transfers are limited to \$50,000 per year.

China and other countries also reportedly have increased scrutiny on such transactions through a host of regulatory regimes including antimoney laundering rules.

MORE ENFORCEMENT

Financial institutions in China should closely monitor the Chinese regulatory and enforcement response in the near term. In the current environment it is increasingly likely that Chinese regulators will strictly enforce fines and penalties in order to raise awareness and to have a public-deterrent effect with regard to noncompliance. This may include prison sentences for individuals for serious violations, personal liability for senior bankers as well as fines and reputational damage.

Financial institutions, including individual officers, directors and “gatekeepers,” also face regulatory and even criminal liability in the United States and in other countries for facilitating the transfer of illicit proceeds, and failing to properly implement the customer-identification protocol and “know your customer” requirements imposed by the antimoney laundering statutes. Moreover, outside accountants, lawyers and consultants may also

be exposed to the extent they facilitate such violations.

Accordingly, for practitioners advising financial institutions in mainland China and Hong Kong, it is important to counsel clients on implementing sound internal control mechanisms and keep abreast of the Chinese regulatory focus in this area.

Also, because accounting firms, consultants and outside lawyers often play a key role with Chinese banking clients, such as setting up trusts and companies offshore, advising and conducting due diligence, it is important for those outside entities to stay abreast of these developments as well.

Ultimately the question is not whether antimoney laundering enforcement is on the rise in China; it is whether the financial institutions, and their advisers, will be properly prepared.



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