Corruption and Risk in China – Insights into the Crackdown on the Pharmaceutical Industry and the Current Environment for Foreign Investment

Brinton M. Scott / Matthew Durham
Winston & Strawn
Shanghai Representative Office

17 October 2013
Overview

• How and why did the crackdown start?
• Where will it lead?
• Not just pharma – what does it mean for your business or investments in China?
• What should you do now? Strategies for identifying and avoiding risk
• Labor – the unique challenges of employees in this context
• Mixed messages? How does the crackdown relate to the overall investment environment
Bring down both the "flies" and the "tigers."

Xi Jinping

Recently, China’s new leadership launched one of the most intense anti-corruption campaigns in decades.

Bo Xilai, a former Politburo member and the biggest "tiger" so far to fall from grace—sentenced to life in prison on September 22nd.

Drive against corruption? Political purge? Or a bit of both?
Macro Context

- Corruption is a mark against the Communist Party
- Social stability is paramount
- Longevity of the Party and the need for economic and social reform
- Reforming State-Owned Entities (SOEs)
- Xi Jinping is consolidating power
- Party plenum in November
- Targeting business (especially foreign business)
Regulatory Authorities Gearing Up and Targeting Foreign Companies

- Started with GlaxoSmithKline (GSK) in June 2013, but has spread rapidly to others in the healthcare and pharma sector
- Pharma seen as easy target, but other industries now in sight
- An element of protectionism
- The private investigator (Peter Humphrey) and sensitivity re information flow
- Targeting foreign companies deflects attention from domestic corruption, investigations and reforms
- Dedicated broad campaign – involvement of other regulatory authorities
- State Administration of Industry and Commerce (SAIC) – to target corruption in business, generally
- Public Security Bureau (PSB) – task force of hundreds of investigators to pursue allegations
- Official campaign means pressure for regulatory authorities to deliver results
The Law – China and Beyond

- PRC law makes bribery a mandatory criminal offense
- Threshold is low – RMB 10,000 (US $1,600)
- Key exceptions – Party members and police
- But penalties are severe
- Potential liability of D&O or “controlling person”
- Enforcement has been selective and inconsistent
- The ripple effect – mandatory reporting under Hong Kong law, FCPA, UK Bribery Act
Identifying Challenges and Areas of Risk – the Environment

• Limited transparency – financial, ownership, property rights, supply chain
• Corporate governance and compliance – “cultural gap”
  — Related party transactions, conflicts of interest, kickbacks, entertainment, tax evasion, agents and vendors
  — SOEs and family businesses
• Local management tribes
• Heavily regulated industries – interaction with officials
• Flow of information and confidentiality
Identifying Challenges and Areas of Risk – the Business

- Challenge of competing and meeting shareholder expectations in one of world’s fastest growing markets
- Policies and training take a back seat to recruitment / growth / profits
- Staff must understand and comply with policies
- Time and cost of screening staff and vendors
- Internal controls (chops, confidential information, etc)
- Turnover in foreign managers and ability to supervise locally and from overseas
- Incentivizing staff with relatively low salaries
- Controlling the behaviors of agents
Looking Ahead – What Should We Do?

- Check on what you have in China – business, structure, practices, procedures
- Internal audits
- Risk assessments
- Policies and training
- Regular reinforcement of policies and training
- Build up knowledge
- Develop a strategy
- Crisis management – be prepared
- “Adequate” procedures may not be enough
## Actively Protecting Your Interests

<table>
<thead>
<tr>
<th>EMPLOY</th>
<th>Screen</th>
<th>staff, partners, vendors…no such thing as too much diligence</th>
</tr>
</thead>
<tbody>
<tr>
<td>THE</td>
<td>Train</td>
<td>intensively 're-educate'; create an ethical expectation from outset … while always keeping cultural and local legal differences in mind</td>
</tr>
<tr>
<td>&quot;S.T.A.I.R.S.&quot;</td>
<td>Audit</td>
<td>financial, compliance &amp; general security records and practices</td>
</tr>
<tr>
<td>CONCEPT</td>
<td>Investigate</td>
<td>allegations of malfeasance</td>
</tr>
<tr>
<td></td>
<td>Repeat</td>
<td>whenever problems or doubts surface, repeat above steps once more</td>
</tr>
<tr>
<td></td>
<td>Systems</td>
<td>have a robust compliance system involving ethics codes, hotlines, etc.</td>
</tr>
</tbody>
</table>

*Courtesy of Control Risks*
Specific Issues re Employees in China

- Employees are involved in every aspect of the business
- Different education system and cultural “norms”
- Growing executive class – the desire to get ahead
- Highly protective, pro-employee labor laws
- Growing sense of entitlement
- Pressure of profits vs. compliance
- “Face” or personal standing
Key Areas of Risk

- Gifts and entertainment
- Agents and sales staff
- Kickbacks and commissions
- Customs – import and export
- Interface with regulatory authorities
- Confidential information and trade secrets
- Property and construction
- Whistleblowing – bona fide or “threat”
Managing Risk

- Business specific risk assessment
- Sufficiency of contracts, handbooks and policies
- Consultation process for implementing policies
- Reporting lines and oversight (especially for off-site agents and sales staff)
- Training and active reinforcement – not just ticking the box
- Language and cultural differences – ensure concepts and implications are clear
- Monitoring and surveillance
- Media and reputation risk
- Consistency of approach and positive action
- Paper trail and signatures
The “Hostage” and the Increasing Power of the Unions

• Chip Starnes / Specialty Medical Supplies China
  — Apparently held “hostage” by employees in Beijing
  — Transfer of employees to different division
  — Apparent failure to communicate
  — Situation could probably have been avoided

• Cooper Tires (US) China JV and acquisition of its stake by Apollo Tyres (Indian company)
  — Apparent resistance to an Indian investor
  — Union not consulted when Cooper established JV
  — Potential “political” interference
  — Authorities reticent to intervene
Strategic Approach

• Plan ahead
• Do the diligence – before and during employment
• Have a strategy
• Communicate clearly
• Paper trail – document, document, document
Risk Analysis

- Many companies have some form of training in place
- Far less have done a full risk analysis or risk matrix – counter-intuitive?
- Revisit policies and training based on risk analysis
- Basic risk matrix:
  - Risk category or nature
  - Description of risk and potential liability
  - Persons affected in company
  - Current controls in place
  - Further controls required
  - Persons responsible for implementing further controls
On a Brighter Note

• The Chinese economy continues to grow
• Increasing sophistication
• Increasing spending power
• Continuing opportunity for foreign business
• Corruption initiative probably linked to reforms
• New Shanghai Free Trade Zone
  — Apparent determination to open up the financial sector and other currently restricted sectors (e.g. value added telecoms)
  — Probably a pilot scheme and exact details still vague
  — Ability to contain and monitor the new initiatives
China’s Urbanization Then
China’s Urbanization Now
Wealth in China Then
Wealth in China Now
What’s in Mrs. Wang’s Purse Today

**Car Keys**: 15.5 million passenger vehicles were sold in China in 2012. GM sold 2.84 million cars in China versus 1.92 million in the U.S. in 2012.

**House Keys**: Mortgages as a proportion of total loans in China have grown from 0.2% in 1997 to 12.9% in 2012.

**Smartphone**: China has over 1 billion cell phone users and more than 500 million internet users. In 2012 Chinese consumers purchased US$ 210 billion worth of goods online.

**Cash and Credit Cards**: There are now over 318 million credit cards in circulation in China, up from just 11 million in 2004.

**Consumer Services**: Chinese urban household consumption will nearly triple from 2012 to 2030, increasing from USD6,190 to USD17,778.

**Itinerary - Las Vegas**: The U.S. issued more than a million travel visas to Chinese citizens in 2012. The wait time for a visa has also fallen from 70 days to 5 days.

Source: ChinaVest Research
What will be in Mrs. Wang’s Purse Tomorrow

**Financial Investments:** Personal investible assets in China totaled US$ 12.89 trillion at the end of 2012. However, over 50% of this total remains in cash and bank deposits.

**Insurance Policies:** Chinese consumers spent US$ 253 billion on insurance policies in 2012, this figure is expected to reach US$ 947 billion by 2020.

**Entertainment:** In 2012, China’s box office revenue reached US$ 2.7 billion. This figure is projected to exceed US$ 10 billion by 2020.

**Personal Health:** Sales of health food and beverages in China reached US$ 37bn in 2010 and are expected to reach US$ 61.7 billion by 2015.

**Little Wang’s Report Card:** Chinese households spent US$ 69.6 billion on private education in 2012. This figure is projected to reach US$ 105 billion by 2015.

**Source:** ChinaVest Research
An international law firm
Questions?
Thank you!