CORPORATE GOVERNANCE

SO YOU'VE SET THE TONE AT THE TOP — NOW WHAT?

PRACTICAL CONSIDERATIONS IN IMPLEMENTING GOOD CORPORATE GOVERNANCE AT THE MIDDLE MANAGEMENT AND STAFF LEVELS IN YOUR CHINA OPERATIONS

*By Paul W. Boltz**

Driven by ever-increasing foreign direct investment by U.S. companies and the fact that the U.S. markets remain a premier destination for initial public offerings (IPOs) by Chinese companies, the economic integration of the U.S. and China has never been higher, and capital flows between the U.S. and China continue to surge. In 2005, U.S. companies were the fifth largest contributors of direct investment in China according to the U.S. State Department. Moreover, more than twenty China-based companies have listed on Nasdaq, with another nineteen on the New York Stock Exchange and literally dozens trading over-the-counter. The underside of this integration is that customary Chinese business practices are being exposed to – or more to the point, *colliding with* – the U.S. regulatory environment on an unprecedented level.

This collision has caused general counsels in the region to become increasingly pre-occupied with the conundrum of wanting to know exactly what is happening in their China operations to avoid legal surprises in the future but, at the same time, fearing that there may be issues so fundamental that they cannot be fixed or that the necessary fix will adversely affect the China operations' profitability. Hand-in-hand with this trend, international law firms which have teams on-the-ground in China that are seasoned in advising Chinese companies are seeing a major upswing in internal investigations of various types, which is a business that simply did not exist several years ago. Concurrently, the number of investigations by the U.S. Securities and Exchange Commission (SEC), which oversees and enforces the U.S. federal securities laws, and by the U.S. Department of Justice (DOJ), which enforces the U.S. Foreign Corrupt Practices Act with the SEC, is also growing rapidly, along with a rise in

---

* *Paul Boltz is a partner based in Morrison & Foerster's Hong Kong office. He has practiced corporate and international securities law in the U.S., Hong Kong and China, with a particular focus on representing companies and investment banks in Asia for U.S. registered and Regulation S/Rule 144A securities offerings. Mr. Boltz also has extensive experience with venture capital transactions and private equity fund formation and investments, including advising clients on forming onshore private equity funds in China. Mr. Boltz is a frequent speaker and writer on corporate governance issues in Asia, and regularly advises companies listed in the U.S. on regulatory and corporate matters.*

securities class action litigation against China-based companies listed in the U.S.

The multiple repercussions of investigations and lawsuits can easily overwhelm a company, including diversion of management's time from the main task of running the company's business, the high costs of settlements and fees for professional advisors and, for some companies, a declining stock price or even delisting. More fundamentally, Chinese companies, including multinational corporations operating in China, may find that corporate governance failures can lead to a wide range of problems, including:

- loss of key licenses or permits in China,
- civil or criminal enforcement actions by the SEC and DOJ, as well as by Chinese authorities, and
- errors in financial reporting and other disclosure at the parent company level.

In addition, for China-based companies seeking to list in the U.S., enthusiasm for these companies among U.S. and international investors could quickly wane, and a great deal of shareholder value could be destroyed, unless they can convince and demonstrate to the capital markets on an ongoing basis that China-based companies do not present a materially higher risk of non-compliance with the securities laws than any other U.S. listed company.

An absolute pre-requisite to avoiding such problems is a commitment by a company's board of directors and executive officers to principles of good, consistent corporate governance in China. This means not only adopting a comprehensive set of internal corporate controls and procedures, but also establishing a "tone from the top" to the effect that senior management expects all employees to comply with such controls and procedures. In fact, most China-based companies listed in the U.S., as well as Chinese joint ventures or subsidiaries of U.S. companies, have adopted a wide range of controls and procedures. These include a code of business conduct, insider trading policy and internal audit procedures, and the public disclosure of these companies often indicates a strong desire to establish a clear tone from the top.

Where many companies tend to become much more passive, however, is in ensuring that middle management and rank-and-file employees in China truly understand the controls and procedures and are committed to adhering to them. Inappropriate conduct by junior employees can often create as much trouble for companies as conduct initiated by the senior officers and managers, and many of the U.S. securities laws impose "strict liability," which means even inadvertent conduct is punishable. It is thus critically important for companies in this situation, their directors and officers, and their advisors such as underwriters for an IPO and independent accountants that the tone from the top translates into action at all levels.

Where Companies and Their Employees Often Go Wrong

The U.S. federal securities laws impose an extremely wide range of requirements, but the conduct which typically gives rise to significant liability exposure in China includes:

- *Incomplete or inaccurate public disclosure* — Material mistakes or omissions in either a company's IPO prospectus or in its ongoing periodic public disclosure (such as annual reports) are by far the most common source of liability under the securities laws for all U.S. listed companies. In recognition of the importance of consistently accurate disclosure, the Sarbanes-Oxley Act of 2002 requires all U.S. listed companies to adopt disclosure controls and procedures to ensure that financial and non-financial information required to be disclosed is recorded, processed, summarized and reported in a timely manner. However, the free flow of information within a Chinese company and with outside advisors such as auditors and legal counsel is often an anathema to staff in China who are more accustomed to purposely controlling information for purposes that may appear entirely mysterious to the outside advisors.
- *Inaccurate books and records* — Unlike Sarbanes-Oxley, which is a relatively new creation, the U.S. Foreign Corrupt Practices Act (FCPA) has been in effect for almost thirty years. The FCPA requires, among other things, that U.S. listed companies maintain accurate books and records to ensure that transactions are executed in accordance with management's authorizations and recorded in accordance with generally accepted accounting principles. Although the original intent of this part of the FCPA was to prevent companies from mislabeling bribes as a more benign form of expense, this has become a favorite cause of action by the SEC against companies that experience internal control and public disclosure problems. In fact, the SEC recently announced the settlement of a long-running investigation of NetEase.com, Inc., one of China's most prominent Nasdaq-quoted companies, which involved allegations of inaccurate book and record keeping.
- *Bribery of foreign officials* — The FCPA also prohibits offers of payments of any kind to a foreign official for an improper purpose in order to obtain or retain business. The FCPA provides only a few, very limited exceptions, and can be violated even if the payment is not actually made and if the expected business is not received. All U.S. listed companies, as well as their subsidiaries and joint ventures, are subject to these prohibitions, even if the bribes have no connection to the U.S. whatsoever. Moreover, Chinese joint ventures and subsidiaries of U.S. companies can potentially be subject to the FCPA even when the U.S. company holds a minority interest in the Chinese business.

Although there are generally fewer actions against companies for violating the anti-bribery provisions of the FCPA in comparison to the number of class action lawsuits filed for improper disclosure, there have been several high profile actions taken by the DOJ and the SEC recently involving conduct in China, including against Diagnostics Corporation and Lucent Technologies. Beyond the sanctions which the DOJ and the SEC can impose, FCPA bribery allegations present significant reputational risk to companies, and can also lead to costly ancillary claims. For example, the discovery of bribery activity could lead to a restatement of a company's financial statements in order to recharacterize the true nature of the bribe payments, which in turn can lead to class action lawsuits for improper disclosure in previously filed annual reports.

- *Insider trading* — It is likely that the employees and management of a Chinese joint venture or subsidiary of a U.S. company would not be subject to the highly detailed insider trading disclosure and short-swing profit provisions of Section 16 under the U.S. Securities Exchange Act of 1934. Moreover, many, though not all, of the China-based companies listed in the U.S. qualify as "foreign private issuers" under the U.S. securities laws, and are therefore exempt from Section 16. Nonetheless, Chinese employees and management remain subject to the general anti-fraud provisions of Rule 10b-5. This rule prohibits the purchase or sale of the listed company's securities while in possession of material non-public information about the company, and also imposes restrictions on "tipping" inside information to third parties.

In turn, Chinese law allows Chinese citizens to buy, hold and sell securities of foreign companies. Although China imposes a wide range of foreign exchange restrictions which make it difficult for PRC citizens to obtain foreign currency to engage in such offshore trading activities, there are several ways for Chinese citizens to obtain foreign currency legitimately (*e.g.,* through the exercise and sale of a stock option for shares in the foreign company). Unfortunately, many Chinese citizens are also able to obtain foreign currency through less than legitimate means as well. Accordingly, it is becoming increasingly common for staff in Chinese companies to open an online brokerage account in Hong Kong or the U.S. and trade in foreign shares from their home computer. Insider trading can result in a number of undesirable consequences. First, the insider who makes the impermissible trades can face significant personal liability. For example, it has been reported in the media that a mid-level vice president of a China-based, Nasdaq-quoted company recently agreed to pay the SEC a fine of US$1 million in connection with alleged insider trading activities. Second, the employer of the inside trader may have to suspend or terminate the trader to avoid any inference that the employer was condoning such conduct, which can disrupt the operations of the employer. Third, the employer faces a general reputational risk in that investors, particularly institutional investors, may lose faith in the company and its senior management if insiders are, for example, dumping shares in advance of negative news announcements.

- *Conflicts of interest* — In contrast to many aspects of the rules applicable to companies listed in Hong Kong, the U.S. securities laws focus on the completeness and accuracy of companies' disclosure, rather than on the substantive merits of what is being disclosed. Accordingly, material transactions with parties that are affiliated with a company are allowed as long as the nature of the transaction is adequately disclosed by the company. Also, if deemed necessary by the company's board and/or required under applicable stock exchange rules, the company may also seek approval of the transaction from an independent body of the board of directors. It is thus incumbent on middle managers and staff to understand what constitutes a conflict of interest so that it can be brought to the attention of more senior management who can decide whether disclosure and/or independent director approval is required. This process is complicated, however, by the sheer volume and frequency of transactions with related parties by some Chinese companies. It is not uncommon to discover in the course of due diligence of a Chinese company attempting to complete an IPO in the U.S. that such company is, for example, substantially dependent on suppliers controlled by relatives of the founder of the company.

How Good Controls and Procedures Can Turn Into Bad Conduct in China

"Is it inherently impossible to run a China-based company in compliance with the U.S. securities laws?" is a common question from management, boards of directors and investors these days. Clearly, on a macroeconomic level, the challenge is daunting, with a significant segment of the Chinese economy being driven by the "guanxi" network of inter-personal contacts among business people and government officials, rather than by the more transparent contract-based approach often followed in western countries. In fact, in its 2005 Corruption Perceptions Index, Transparency International places China at 78th out of 158 rankings, on par with Senegal and Suriname.

The central task for senior management and boards of directors, whether in China or in the parent company in the U.S., if applicable, is thus to clearly define on a task-by-task, day-to-day basis how their companies can operate effectively in this environment, while still observing applicable U.S. laws. Nonetheless, such efforts will ultimately be doomed to failure if the company cannot dispel three pervasive (and mistaken) attitudes which are common among many Chinese employees. Each of these attitudes is rooted in the fact that China is developing very quickly and has only limited experience with a contract-based system of business and with a highly comprehensive and well-supervised body of laws like the U.S. securities laws.

The "Customary Practice In China Can Trump Written Contracts" Fallacy

Many employees in China-based companies simply assume that what they perceive to be a customary business practice in China or in their industry is the de facto legal standard to which they should adhere. This is true even if such practice is inconsistent with written laws or contracts. Thus, middle managers may disregard the terms of contracts with suppliers, and instead calculate the fees due to the suppliers based on a formula that the middle managers have heard their competitors use. In turn, this miscalculation can lead to inaccurate financial statements and disclosure regarding the relevant contracts.

This fallacy is especially insidious and difficult to root out because the employees will often genuinely believe that their approach is legal and appropriate. In other words, they do not feel they are doing anything wrong, and accordingly, see no need to highlight their practices with senior management, the board of directors or the company's outside auditors and legal counsel. Companies can thus glide along for years without ever realizing that they have serious compliance problems until, for example, the day the counter-party to a contract decides to audit the company's records or the outside auditors start to identify discrepancies between amounts recorded in the company's books and the amounts payable under the company's written contracts. In addition, a company can be placed in the extremely difficult situation of having a major portion of its middle management and staff unknowingly involved in inappropriate conduct, while the SEC is demanding that the company identify who are the "guilty parties" and take appropriate remedial actions such as terminating them. The SEC is generally unimpressed with the defense that the conduct was inadvertent and systemic and, therefore, no one should be punished.

The "They'll Never Catch Me" Fallacy

For most middle management and staff of China-based companies, the SEC, DOJ, class action litigation and the U.S. securities laws in general seem impossibly far away and far removed from their day-to-day activities. Consequently, middle managers and staff often believe that their conduct will never be subject to the scrutiny of the SEC or class action plaintiffs' lawyers and, therefore, they do not need to take the company's controls and procedures particularly seriously. This attitude has been proved false in a wide variety of contexts. For example, the stock exchanges in the U.S. operate sophisticated software programs which monitor hundreds of millions of transactions to identify unusual trading activity which may constitute insider trading. When potentially unusual trading activity is identified, the stock exchanges will send the company a letter with a list of names who have engaged in suspect trades and demand that the company identify which names it knows. In some cases, it is the middle managers and staff of the company themselves on the list, who are stunned to learn that their typically small trades (in some cases conducted through a relative's Internet brokerage account) have caught the attention of the stock exchanges. As noted above, this can subject traders to significant personal liability and dismissal from their position with the company.

Furthermore, unlike many jurisdictions, in the U.S. class action plaintiffs generally have broad discovery rights, meaning that the company may be required to turn over large amounts of documents to the plaintiffs for their review. In its investigations, the SEC will also demand that the company voluntarily turn over documents and may even seek to depose company employees in China. Even if the problem at hand does not result in class action litigation or SEC investigation, the company's outside auditors will often demand that the company conduct an internal investigation if they suspect misconduct within the company. All of this means that no employee of a U.S. listed company (or its Chinese joint venture or subsidiary) and no internal document can definitely be considered out of reach of the U.S. securities laws.

The "Even if They Catch Me, They Can't Reach Me" Fallacy

For middle managers and staff that are caught engaging in inappropriate conduct, an all too common reaction is "So what? I don't live in the U.S. Let the SEC come to my province in China and punish me." It is not a completely unfounded position as the SEC and plaintiffs' lawyers have very limited reach into China. Nonetheless, having to defend against enforcement proceedings in China based on a U.S. securities judgment is not the only risk a defendant that ignores the SEC or U.S. courts might face. For example, U.S. regulatory authorities such as the SEC or the body supervising the stock exchange where the parent company's stock is traded might take a dim view of companies and employees which ignore U.S. court proceedings. Delisting proceedings or other government sanctions could follow, which could seriously impair the value of an employee's shares and stock options.

In addition, even if an employee has no assets in the U.S. at the time of the suit, if he or she acquires such assets later or even opens a bank account with a U.S. bank, those assets might be seized to satisfy a judgment. An employee's travel within the U.S. could also be subject to interference. As a result, while employees of China-based companies can enjoy some insulation from the consequences of their actions under the U.S. securities laws due to their location, such employees should understand that they are not completely out of reach. Moreover, they can quite easily lose their jobs for violating company controls and procedures.

Translating the Tone at the Top to Action at All Levels

No single internal control or procedure or pronouncement by senior management will transform a China-based company into a model of corporate governance. Rather, it requires a steady, systematic approach that concentrates on reaching middle managers and staff on a regular basis and in a manner which is readily applicable to their day-to-day responsibilities. This approach should include:

- **Adopting controls and procedures that are easy to understand and enforce —** Some U.S. companies have adopted elaborate controls and procedures which provide numerous exceptions and enable employees to exercise their discretion in certain instances. For example, the insider trading policies of some companies only apply to certain designated individuals who may come in contact with material inside information and allow trading outside of open "trading windows" if approved by the company's compliance officer. Such a policy has the advantage of offering flexibility to the company and minimizing unnecessary restrictions on the employees as a whole. On the other hand, many China-based companies are not experienced in administering this kind of policy, and employees may become confused as to what they can and cannot do. Consequently, some China-based companies have opted to adopt controls and procedures that are easier to understand and enforce such as an insider trading policy that applies to all employees, regardless of position, and bans trades outside of the open trading windows altogether.
- **Translating controls and procedures and giving live presentations on a regular basis —** A surprising number of China-based companies have at least one internal control or procedure which either has not been translated into Chinese or has been translated poorly. It is these controls and procedures which are most often misunderstood or completely forgotten, even by senior management. As a result, care and attention must be invested by senior management in creating a complete and accurately translated employee handbook which contains all relevant information in a single, easy-to-reference place.

  In addition, some companies will give a few presentations to employees on internal controls and procedures shortly after the company is formed or after the initial public offering is complete and then never do further training unless a problem arises. The senior management of these companies will then often take what the former SEC Chairman Harvey Pitt has coined the "Wizard of Oz" approach by sending out periodic emails to employees with generalized messages such as "Don't forget that the company has a code of business conduct." Such messages tend to have little impact as they do not explain how the controls and procedures work, who administers them and why the company has adopted them in the first place. Moreover, newer employees may not even know where to find a copy of the policy. Thus, constant training and re-training, which is specifically formulated and tailored to address the everyday situations middle management and staff regularly face and is presented in a level of detail the audience can understand, is essential. The training should also be conducted with an eye toward specifically dispelling the "they'll never catch me" and "even if they catch me, they can't reach me" fallacies.

- **Explaining the importance of written contracts and the dangers of relying on perceived China or industry practice —** Senior management, ideally with the assistance of qualified in-house counsel, must remind middle management in China that the company enters into contracts for a reason, where they can find such contracts and whom they should consult about their interpretation. Moreover, clear processes for approving deviations from contracts should be implemented. Conversely, middle management should be encouraged to communicate up the ladder to senior managers if they believe the company is entering into contracts that are out-of-market. This message should be made an integral part of the regular training described in the bullet point above.
- **Connecting the dots between corporate governance, stock performance, and stock options —** Stock options are a relatively new phenomenon in China, and many Chinese employees have the impression that they essentially represent cash in an account that they can automatically access at fixed dates in the future. Accordingly, senior management should not underestimate the importance of explaining the connection between good corporate governance, stock performance and the value of employee stock options. This simple but fundamental message can strongly encourage employees to take ownership of compliance with the company's controls and procedures within their respective areas in the company.
- **Taking tips seriously —** Whether in China or elsewhere, prompt investigations into tips of potential internal misconduct are important in identifying problems and eliminating, or at least minimizing, the liability which could result from the problems. The importance of such an investigation with appropriate board supervision is heightened in China because senior management may be prone to jumping to the conclusion that the misconduct resulted from the fallacy mentioned above that everyone in the industry is doing it and the staff did not intend to engage in fraudulent conduct, so no punishments are warranted. That justification may turn out to be legitimate, but the board and senior

management will be judged in hindsight on their determination. Accordingly, if they have not conducted a sufficiently thorough and timely investigation, the SEC, DOJ or a U.S. court could later conclude that the company did not take appropriate remedial actions.

- **Making sure that executive officers take responsibility for determining what is material disclosure —** While sensitizing middle managers and staff of China-based companies listed in the U.S. about the company's disclosure obligations and what constitutes material information is a worthwhile task, it is unrealistic to expect that they will be able to become experts on these subjects. Senior management of such companies must therefore maintain hands-on involvement in the preparation and analysis of all public disclosure pursuant to the company's disclosure controls and procedures. Situations where senior management distributes last year's annual report to middle managers with instructions to update where necessary and then give it to the company's outside counsel for polishing and filing with the SEC run a high risk of liability. Middle managers will often not be cognizant of the fact that the company's business has changed in some fundamental way which would require an entirely new disclosure presentation or may not understand how developments in other departments may affect their own department. Similar concerns arise in the context of U.S. companies which have significant China operations and must rely on their senior managers in China to provide relevant information upstream so the parent company's disclosure is accurate.
- **Enforcing controls and procedures and publicizing punishments internally —** Enforcing all corporate controls and procedures in China can be exhausting for some companies. In certain cases, senior management in China bends to the pressure. For example, senior managers may adopt what appear to be robust policies that they show to investors and outside auditors and counsel (or to their U.S. parent company), but they know such policies will probably not be complied with out in the field. In the case of China-based companies listed in the U.S., a strong, independent board serves a critical function in this instance by questioning senior management about what they actually do to oversee the corporate governance and finances of the company. While board oversight is no guarantee that all problems will be identified, it can help senior management focus on key issues, such as whether unusually large miscellaneous expenses incurred by a sales manager in the field may represent a "red flag" that the manager is bribing local officials.

  In the case of a U.S. company with a joint venture or subsidiary in China, enforcement can be particularly problematic if the

U.S. company does not have operational control of the Chinese business. As a result, foreign companies establishing operations in China with a domestic partner should ensure they negotiate adequate rights so that they can effectively monitor such operations. Those rights can include the power to appoint or remove the general manager of the China operations, make frequent site visits, have periodic access to books and records and conduct an internal audit review.

Finally, punishments for violations of controls and procedures must be publicized within the company to ensure that employees understand that their actions can have very definite consequences. As noted above, this is often a surprising concept to middle management and staff who assume that they cannot be caught.

Conclusion

The increasing number of class action lawsuits and SEC and DOJ actions involving conduct originating in China demonstrates that we are in a turbulent period. But, another more optimistic way to view the current state of the market is that each of these events reinforces to the business community in China just how important good corporate governance and compliance with the U.S. laws are to long-term success if they want to list in the U.S. or enter into partnerships with U.S. companies. It is too soon to tell whether these lessons will be taken to heart by the Chinese business community.