

## CEP Magazine – March 2020

# The financial compliance risks of business with China

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**This is the second article of a three-part series on managing your company's compliance risk with China.**

In the first part of this series, we discussed how China's exports have, for decades, created steady work for US trade and product safety compliance professionals. More recently, China's economic strength, combined with its state capitalist economic and political systems, creates political compliance risk for Western companies operating there.

Here we will look at an entirely separate and growing compliance risk for people and companies doing business with China: financial compliance risk. The risks can be grouped into two broad categories: (1) risks under domestic law arising from a company's business dealings with Chinese individuals and corporations, and (2) risks to your company related to its operations in China.

### US law and China's outbound riches

For the last 30 years, wealthy and connected Chinese individuals and businesses didn't need to leave home to find attractive investment opportunities. Steadily rising property prices made thousands of politically connected real estate developers fabulously rich. The world's insatiable appetite for Chinese-made goods, combined with free trade, built enormous industrial and consumer product fortunes, particularly in the southern cities of Shenzhen and Guangzhou.

But over the last ten years the game changed, sending Chinese investors out into the world looking for growth. It has been a "perfect storm" for capital flight: a trade war, a rapidly slowing Chinese economy, a weakening national currency, wealth with sometimes questionable or even corrupt origins looking to get "clean," and strict limits on how much money Chinese people can legally take out of the country. All these forces have converged to push money out of China and spawn new cross-border financial compliance risks for people and companies dealing with China. If you are a compliance professional in the financial services industry and your company does substantial business with Chinese companies or investors, your risk radar should be ringing.

Wealthy Chinese investors, and their bankers, lawyers, and accountants, have devised many creative—but not always entirely legal—methods for getting money out of China and into attractive foreign investments. This is not to say that your company's Chinese partners, customers, or investors are out to break the law. They may not, however, have knowledge of and respect for the laws and regulations operating in their target country. It is up to you, the global compliance professional, and your company's financial and legal teams, to be at the table to manage those risks.

Many laws come to bear upon cross-border investment flows and overseas business operations. The following discussion is a selection of important laws, but is certainly not intended to cover all points of global financial

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regulation and compliance risk management across multiple countries. The laws and regulatory regimes referenced here have spawned their own legal and accounting subspecialties. Risk management arising from these laws, therefore, should be addressed in partnership with specialists in your company's finance and legal departments long before a deal starts to come together.

## Anti-money laundering

Anti-money laundering laws combat the movement of money—usually across national borders—from illicit or criminal activities, like corruption, drugs, or human trafficking, into legitimate channels and investments. In the US, money laundering is attacked through a body of anti-money laundering (AML) regulations promulgated under the Bank Secrecy Act of 1970<sup>[1]</sup> and its amendments (Foreign Assets Control Regulation, 31 C.F.R. § 500 ; Financial Record Keeping and Reporting of Currency and Foreign Transactions, 31 C.F.R. § 1010.310 ; Procedures for monitoring Bank Secrecy Act compliance, 12 C.F.R. § 21.21 ; Reports of Suspicious Activities, 12 C.F.R. § 21.11 and 12 C.F.R. § 163.180 ; and USA Patriot Act, Pub. L. 107–56. 115 Stat. 272 (Oct. 26, 2001)). These laws look to prevent money made through illegal activities from becoming “clean” and thus useful to the criminals who earn it. Foreign criminals often want their ill-gotten gains to be converted into a reserve currency (dollars, euros, or pound sterling) and moved offshore. Dirty money from China normally passes from the Mainland through an underground bank to a foreign currency-denominated account in Hong Kong or Singapore. The final step in the laundering is to use the money in an otherwise legitimate commercial transaction—possibly with your company.

Of particular concern regarding China is money traced to government officials engaged in corruption and, lately, earnings from the country's illegal drug exports. Bad guys everywhere are especially fond of cryptocurrencies because some of the newer ones, like monero and Zcash, cannot yet be traced.<sup>[2]</sup> My advice is to run away—quickly—from any foreigner looking to pay in crypto.

Of course, most Chinese individuals and companies are on the up-and-up. Yet even if you are satisfied that your Chinese partner is not engaged in criminal activity, you aren't out of the woods. It is hard to learn anything meaningful about Chinese companies, because Chinese corporations law allows them to mask their true ownership and actual business activity, if they wish.<sup>[3]</sup> China has different accounting standards that, among other concerns, allow company annual reports to hide liabilities and mis-characterize (by Western standards) company assets. For example, Caterpillar had to write off \$580 million of an investment in a Chinese company when its accountants failed to discover that the Chinese company didn't possess many of the assets reported in its financial filings.<sup>[4]</sup> Is the company going to be there in a year? Is the money they're wiring you clean? If you are dealing with an individual, does the transaction violate any Chinese laws on foreign capital transfer? Several “know your client/partner” and blockchain analytic services like Chainalysis have sprung up to help American businesses find out more about their Chinese clients, partners, vendors, and investors, and the true sources of their funds.<sup>[5]</sup>

## CFIUS

If Chinese investors come knocking on your American tech company's door, it is likely that the Committee on Foreign Investment in the United States (CFIUS) will take an interest. It wasn't so long ago that high net worth Chinese investors and government-owned corporations roved the world, snapping up attractive technology companies in the US and Europe. The Chinese buy what they cannot build. Computer chips are a good example. The Chinese government's hugely expensive and largely failed effort to underwrite a viable domestic Chinese semiconductor industry means that Chinese tech manufacturers are still heavily reliant on foreign chip suppliers.

CFIUS is an interagency body of the US federal government authorized to review certain transactions involving foreign investment in order to determine the effect of such transactions on national security.<sup>[6]</sup> The committee operated out of the public eye for decades, but in 2018, a rising, acquisitive China brought about substantial enhancements to the law authorizing and empowering CFIUS.<sup>[7]</sup> Nowadays, if a Chinese company is looking to invest in your company (or even do a simple joint venture), and if your company is engaged in technology that could in any regard be considered vital to national security, then the investment may be blocked by CFIUS. Software, social media, semiconductor, biotech, and leading-edge technologies like artificial intelligence are a particular concern. In recent years CFIUS has blocked several proposed Chinese acquisitions of US companies.<sup>[8]</sup>

Let's move now to the financial compliance risks that your company might face arising out of its operations in China.

## **China's 'corruption problem'**

Corruption is defined as the abuse of entrusted power for private gain.<sup>[9]</sup> Corruption always involves a government official abusing their position to do something that brings a benefit to themselves. The benefit these corrupt officials often seek is a payment (a bribe) or some other thing of value in return for an act they perform in their official capacity. The U.S. Foreign Corrupt Practices Act (FCPA) prohibits public companies (both foreign-based and domestic) that are listed on US stock exchanges from bribing foreign government officials.<sup>[10]</sup> The UK's foreign anti-corruption law, the Bribery Act, is even more stringent in its liability scheme, but the UK government has not enforced this law as aggressively as the US. Your company's FCPA compliance is rightly characterized as financial in nature because the law is enforced through irregularities in the financial information that a company files with securities regulators.

China has made great strides in the last decade to get its runaway corruption under control. Nevertheless, it is still only ranked as the world's 87th least corrupt country in the 2018 Corruption Perception Index of Transparency International. (For comparison, Denmark came in at #1, perceived as having the world's least government corruption; the U.S. came in at #22, one spot ahead of Uruguay and one spot below France.)<sup>[11]</sup> China still has a big corruption problem, especially involving foreign companies, which are usually seen as rich and relatively unsophisticated, and thus the most attractive targets for corrupt officials.

What should get your attention as a compliance professional is the eye-watering US foreign corruption settlements that have recently been extracted from companies. In June 2019, Walmart settled a seven-year global corruption investigation for \$282 million.<sup>[12]</sup> The US government recently announced a whopping \$1.1 billion settlement with Sweden-based telecommunications company Ericsson (NASDAQ: ERIC) for corrupt payments the company made over the span of two decades to government officials in several countries, including China.<sup>[13]</sup>

## **The corporate social credit system**

You may have heard of China's somewhat Orwellian social credit system intended to regulate the behavior of its citizens. The scheme is being piloted in several Chinese cities and will be rolled out on a national basis over the next several years. Records are maintained on citizens regarding all nature of transgressions, from traffic tickets and breach of contract to arguing with your neighbors. Violators lose the right to travel abroad or use China's excellent high-speed train system. The children of violators may be denied admission to desired schools.

In a move that is certain to create a huge China compliance cottage industry, the Chinese government will roll out a corporate social credit system for businesses—both foreign and domestic—in 2020.<sup>[14]</sup> Though not exclusively a financial compliance initiative, the goal of this system is to keep all businesses in compliance with national

directives. The system is quite likely to require extensive compliance reporting, which could easily run afoul of Western employee data privacy laws. Filing requirements of a commercially sensitive nature are likely to include business contracts. Measures of a company's social responsibility, and even the number of communist party members it employs, are likely targets for companies to hit—or else. Penalties for noncompliance will be typically draconian. Jörg Wuttke, president of the EU Chamber of Commerce in China, made a grim forecast for foreign companies operating in China under this system: “Corporate social credit could mean life or death.”<sup>151</sup>

In this installment on China compliance, we have highlighted some of the main financial compliance risks that business in China, and with Chinese people and companies, might represent for your company. Money is leaving China, looking for attractive investments in the West. This raises several financial compliance red flags. US anti-money laundering laws seek to prevent ill-gotten money from being legitimized for use in normal business transactions. A proposed investment from China may attract the attention of CFIUS, which scrutinizes foreign investments that may compromise US national security. The FCPA has resulted in hefty fines for US and foreign companies whose overseas employees bribe foreign government officials. China's Corporate Social Credit system, when implemented this year, is certain to increase the regulatory and compliance burdens of all companies operating there.

Next month, in the final installment of this series, we will detail methods that you and your company can take to manage or mitigate the compliance risks detailed in Parts 1 and 2 of this series on China compliance.

## Takeaways

- Money continues to pour out of China, looking for attractive investments in the West.
- US anti-money laundering laws seek to prevent ill-gotten money from being laundered for use in legitimate business transactions.
- The Committee on Foreign Investment in the United States scrutinizes foreign investments that may compromise US national security.
- The Foreign Corrupt Practices Act can land US and foreign companies in hot water for the illegal acts of their foreign employees.
- China's Corporate Social Credit system, when implemented, is certain to increase the regulatory and compliance burdens of all companies operating there.

<sup>131</sup> U.S.C. § 5311–5330 .

<sup>2</sup> Jeffrey Francis, “Ways to Track Monero and Zcash Sought by U.S. Government,” *Live Bitcoin News*, December 7, 2018, <http://bit.ly/35BCD5G>.

<sup>3</sup> “China's murky ownership rules: Who owns what?” *The Economist*, July 7, 2011, <https://econ.st/2NfbD5E>.

<sup>4</sup> Naomi Rovnick, “Caterpillar's China accounting scandal is all too common,” *Quartz*, January 21, 2013, <http://bit.ly/2QEcuxx>.

<sup>5</sup> <https://www.chainalysis.com>.

<sup>6</sup> 50 U.S.C. § 4565 .

<sup>7</sup> Foreign Investment Risk Review Modernization Act of 2018 (FIRRMA), National Defense Authorization Act, Title XVII, Review of Foreign Investment and Export Controls, Subtitle A, “Committee on Foreign Investment in the United States,” § 1701.

<sup>8</sup> Greg Roumeliotis, “U.S. blocks MoneyGram sale to China's Ant Financial on national security concerns,” *Reuters*, January 2, 2018, <https://reut.rs/2lIEh1g>.

- 9** “What is corruption,” Transparency International, accessed January 10, 2020, <http://bit.ly/2QDEX4M>.  
**10** 15 U.S.C. §§ 78dd-1, et seq.
- 11** “Corruptions Perceptions Index,” Transparency International, accessed January 10, 2020, <http://bit.ly/3061fm2>.
- 12** Nandita Bose, “Walmart to pay \$282 million to settle seven-year global corruption probe,” *Reuters*, June 20, 2019, <https://reut.rs/2QHAYkD>.
- 13** Department of Justice, “Ericsson Agrees to Pay Over \$1 Billion to Resolve FCPA Case,” news release, December 6, 2019, <http://bit.ly/2NtS2Pt>.
- 14** Thomson Reuters, “China’s corporate social credit system to raise big risk, compliance challenges for multinationals,” November 14, 2019, <https://tmsnrt.rs/2QXQQo4>.
- 15** South China Morning Post, “Social Credit Means ‘Life or Death,’” *Abacus News*, August 28, 2019, <http://bit.ly/2NeqDkq>.

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