THE NATIONAL
LAW JOURNAL
An ALM Publication

NOVEMBER 15, 2010

Online Feature

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How Hong Kong cleaned up its capital markets

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Any discussion of corruption in China invariably starts with the concept of "guanxi" and the integral role it plays in Chinese society. Literally meaning "social relationship" or "social connection," it is ostensibly analogous to Western concepts of "old school ties" and alumni networks but operates more subtly and extensively, and the line between guanxi and bribery is all too often unclear. It can be used to describe the personal connection between two people by which one is able to prevail upon another to perform a favor, or an entire network of connections on which an individual can call and through which he can exert influence.

Guanxi is typically established through the provision of personal favors, hong bao (red packets containing money), gifts, entertainment or other benefits to which the recipient ascribes value, thereby activating obligations of mutual assistance between the parties. In China and throughout Asia generally, these ingrained customs and practices are further underlined by the financial and political influence accumulated by, and concentrated in, the hands of a few powerful families.

Once one of the most corrupt cities in the world, with widespread corruption in the public sector and the law enforcement services, Hong Kong is now one of the cleanest. The 2010 Corruption Perceptions Index, Transparency Inter nation al's survey of government transparency and public-sector corruption, ranked Hong Kong at 13th in the world, ahead of the United Kingdom at 20th and the United States at 22d. Transparency International Corruption Perceptions Index.

Hong Kong's success is due in large part to the Independent Commission Against Corruption (ICAC), which the Hong Kong government formed in response to the public outrage that ensued when a senior police officer fled the city while under investigation for corruption. Since its inception in 1974, the ICAC has used its wide-ranging investigative and other powers to combat public-sector corruption and in recent years has turned its attention to private-sector corruption, setting up an advisory group to identify and provide advice to private companies regarding vulnerabilities in their systems and controls. As a result of the ICAC's success, guanxi, while undoubtedly still relevant in forming business relationships, is no longer the driving factor it once was in Hong Kong.

With Hong Kong firmly established as a globally important financial center, insider dealing and other instances of market abuse have become a growing concern, and the city's Securities and Futures Commission (SFC) is now a crucial partner in the ICAC's efforts to keep Hong Kong's capital markets free from corruption. Although such offenses have historically been punished with monetary penalties, in September 2009 former Morgan Stanley managing director Du Jun was convicted of insider dealing and sentenced to an unprecedented seven years in prison. Kelvin Wong, "Former Morgan Stanley Banker Du Jailed for 7 Years," Bloomberg News.

PROMINENT PROSECUTIONS

A further example of the SFC's growing power is the case of Leung Sze-Chit, a senior manager of accounting firm KPMG LLP, who in 2009 was accused of bribery.

The ICAC accused Leung of offering $12,900 to his subordinate in connection with the initial public offering by Hontex International Holdings Co., which raised nearly $129 million. The SFC in turn suspended trading of the company's shares and alleged that Hontex had disclosed misleading information in its December 2009 prospectus, and in April 2010 obtained a court order freezing the Hong Kong assets of Hontex and four subsidiaries. The cases are pending, and Hontex in August announced its intention to compensate investors as a result of its investigations into the SFC's allegations. Hontex-SFC press release, April 8, 2010; Hontex announcement, Aug. 30, 2010.

In stark contrast, China was ranked by the CPI at 78th in the world. Corruption is and has for years been rife in China, contributing to economic inequality and instability and fuelling social unrest. China's exponential growth in recent years has seen an influx of international businesses, and similarly a growing presence in Hong Kong and international jurisdictions of Chinese businesses. As China continues to relax controls on foreign exchange, and with the authorities taking ever more aggressive stances in enforcing anti-corruption measures, the issue of corruption in China is increasingly relevant to organizations looking to do business with their Chinese counterparts.

Parties to business transactions in China have historically relied upon interpersonal relationships rather than look to the Chinese courts to enforce contracts. Guanxi therefore remains of paramount importance and high barriers to entry are common in the Chinese markets. However, the tools used to establish guanxi and gain entry often conflict with anti-corruption laws. See *U.S. v UTStarcom Inc.*, Department of Justice Release (Dec. 31, 2009), in which the telecommunications company provided Chinese officials with trips to the United States in the course of its business-development activities, and ultimately settled actions by the Department of Justice and the Securities and Exchange Commission by paying $3 million in fines.

International businesses attempt to circumvent these entry barriers through the use of local joint-venture partners or other third parties who already hold the relationships necessary to found a successful business, but the use of local third parties is not without its own risk. The Foreign Corrupt Practices Act (FCPA) prohibits corrupt payments through intermediaries, and an organization will be liable if it makes a payment to a third party while knowing (which includes conscious disregard and willful blindness) that all or a portion of the payment will go directly or indirectly to a foreign official. See 15 U.S.C. 78dd-1(a). Section 7 of the Bribery Act 2010 (due to come into force in the United Kingdom in April 2011) creates a similar offense for U.K. organizations, unless they had in place adequate procedures designed to prevent such occurrences.

In addition to the implementation of internal systems to guard against corruption, therefore, any organization looking to enter into an arrangement with a local third party must ensure it conducts comprehensive due diligence and is vigilant in watching for warning signs — links to public officials and government departments, requests for cash payments or payments to private accounts or seemingly inadequate bodies of staff with little or inappropriate experience and expertise.

STATE-OWNED ENTERPRISES

In China, the problem is further compounded by the high level of state-owned enterprises and public officials participating in the marketplace. The FCPA's definition of "foreign official" includes employees of any entity that constitutes an "instrumentality" of a foreign government (15 U.S.C. 78dd-1(f)(1)(A)). State-owned enterprises in China are considered by the U.S. authorities to be instrumentalities of the Chinese government, provided that the Chinese government has some form of ownership and control over the organization, and consequently their employees fall within the definition of foreign official under the FCPA even though the organization operates in the private sector.

Although China has yet to implement a cohesive anti-corruption regime, it is nevertheless clear that the Chinese government recognizes the need to combat corruption if the country is to do business on an international scale. The principal pieces of anti-corruption legislation in China are the Criminal Law of the People's Republic of China, under which serious cases of bribery are offenses, and the Anti-Unfair Competition Law covering commercial bribery. Notably, foreign bribery by Chinese businesses is not covered, although legal reform is planned.

The Chinese government has also launched a series of initiatives to address both public- and private-sector corruption, and it has established 24-hour corruption hot lines involving a myriad of government agencies. It has visibly stepped up enforcement efforts in recent years, and this is plainly evidenced in the case of Huang Guangyu. Born into a poor family in Guangdong, Huang and his brother founded Gome Electrical Appliances Holdings Ltd. Gome was listed on the Hong Kong Stock Exchange in 2004 and by 2008 Huang was named as the richest man in China. In November 2008, Huang was detained by Hong Kong's police force on allegations of stock-price manipulation. The trading of Gome shares was suspended and, in August 2009, a Hong Kong court froze Huang's assets. In May 2010, Huang was convicted of insider dealing, manipulating stock trading and bribery, having paid five senior government officials more than $598,000 in the form of cash and properties in exchange for corporate benefits. A Beijing court sentenced Huang to 14 years in jail with a fine of $88 million. This matter, and investigations by the Hong Kong authorities, are continuing. "Chinese tycoon Huang Guangyu jailed for bribery," BBC News.

There is little doubt that the elimination of systemic corruption has become a strategic cornerstone for the Chinese government, and that it is increasingly an important consideration for Hong Kong and the global business world. What remains to be seen is whether China can take Hong Kong's example and achieve equally clear results in the fight against corruption.

Ultimately, widespread corruption is a reflection of societal perceptions and attitudes, and until traditional concepts of guanxi are modernized, organizations hoping to do business in China must adjust their operational practices, make sure they conduct proper due diligence and ensure that they have sufficient checks and systems in place to protect themselves from charges of corruption.

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