

# CHINA MATTERS

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## Technology Companies Operating in Asia Remain a Focus for FCPA Enforcement

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Technology companies doing business in Asia continue to face increased scrutiny by federal regulators for potential violations of the Foreign Corrupt Practices Act (FCPA). In recent months, the Department of Justice (DOJ) and the Securities and Exchange Commission (SEC) have dramatically increased the number of FCPA investigations involving business activities in Asia, particularly in China.<sup>1</sup> This focus is compounded by the long-standing scrutiny of technology companies, which have historically strong ties to suppliers and manufacturers in the region. Following the SEC's formation of a San Francisco-based FCPA unit designed specifically to target technology firms operating in Asia,<sup>2</sup> we expect technology companies will continue to be in the crosshairs of government regulators for the foreseeable future.

The business model and markets for technology companies render them prone to special risks of which government regulators are aware. In particular, the fastest-growing markets for technology companies are in Asia, where gift-giving remains a cultural norm and where emerging markets have not dedicated the necessary resources to root out corruption. The pricing and discount models used by technology companies also create potential risks that discounts will be manipulated to pay for lavish entertainment expenses or gifts to government officials. Moreover, in

some Asian markets, foreign companies cannot do business directly with a state-owned or controlled entity, rendering necessary the use of third party intermediaries and thereby increasing the risk that an improper payment may be made.

A recently settled SEC enforcement action against San Jose-based Veraz Networks, Inc. (Veraz) is indicative of the SEC's heightened focus on technology companies operating in Asia. Veraz settled books and records and internal control charges based on claims of a "gift scheme" and efforts to make improper payments, through a consultant, to foreign officials in China and Vietnam. The SEC alleged that Veraz violated the FCPA shortly after the company went public in 2007 and imposed a fine despite the fact that the actual bribe payments had been limited to \$4,500.

The pervasiveness of corruption in China, coupled with the Chinese business culture of gift giving and reciprocal exchange of favors, presents a very challenging anti-corruption compliance environment for U.S. companies. The Veraz settlement is yet another illustration of the need for U.S. companies to ensure that their compliance programs are robust at the outset. The relatively small and isolated conduct alleged against Veraz also demonstrates

the SEC's low threshold for potential violations in this area.

### **Heightened Scrutiny of Technology Companies Operating in Asia**

Almost a year after the SEC formed a dedicated FCPA enforcement unit in Washington, D.C., a regional FCPA team was created in the SEC's San Francisco office. Dedicating long-term resources for a West Coast FCPA team signals an increased and sustained focus on technology companies and business activities in Asia. Tracy Davis, Assistant Regional Director and head of the San Francisco FCPA team, explained that the "significant presence of companies in Silicon Valley who do business internationally, specifically in Asia, makes us well-suited for addressing these kinds of issues. That's one of the reasons why San Francisco is a particularly good location for an FCPA unit."<sup>3</sup>

Only weeks after the SEC's San Francisco unit was formed, on June 29, 2010, the office filed, in the Northern District of California, the aforementioned enforcement action against Veraz, a telecommunications provider, for allegedly failing to accurately record improper payments on its books and records and failing to devise and maintain a system of internal controls to prevent such payments.<sup>4</sup> According to the SEC's complaint, "from 2007 to 2008, Veraz resellers, consultants, and employees made and offered payments to employees of government-controlled telecommunications companies in China and Vietnam with the purpose and effect of improperly influencing these foreign officials to award or continue to do business with Veraz."

With respect to payments in China, the SEC alleged that Veraz engaged a consultant in China to assist Veraz in selling products to a state-owned telecommunications company. The SEC claimed that the consultant provided approximately \$4,500 worth of gifts to officials of the telecommunications company to secure the contract and described a particular payment as a "gift scheme." The complaint further alleged that the consultant offered a "consulting fee" of 15 percent to employees of the telecommunications

company to help obtain the contract valued at approximately \$233,000. Veraz discovered the offer and cancelled the sale before any payment was made.

With respect to payments in Vietnam, the SEC alleged that Veraz sold products to a telecommunications company controlled by the government of Vietnam through a Singapore-based reseller. The SEC claimed that a Veraz employee, through this Singapore-based reseller, made or offered illicit payments to an officer of the Vietnamese company. The SEC further alleged that Veraz approved of, and reimbursed an employee for, certain questionable expenses, including gifts, entertainment, and flowers for the wife of the Vietnamese company's chief executive officer.

Without admitting or denying the allegations, Veraz consented to entry of a final judgment permanently enjoining it from future violations of the FCPA and ordering Veraz to pay a \$300,000 civil penalty.

While a formal FCPA unit in San Francisco is a recent development, the enforcement staff in the region is not new to FCPA enforcement. On December 31, 2009, the San Francisco office filed a complaint against UTStarcom, Inc. (UTStarcom), a Bay Area telecommunications company, alleging that UTStarcom spent nearly \$7 million on "lavish gifts," overseas "sightseeing" trips, and all-expenses paid executive training programs in the U.S. for Chinese foreign government customers. That action, coupled with a parallel action brought by the DOJ, resulted in disgorgement and penalties of approximately \$3 million. The company also faced a civil securities fraud lawsuit which it recently settled for \$30 million.

In 2006, the San Francisco office instituted cease-and-desist proceedings against Oregon-based Schnitzer Steel Industries, Inc. (Schnitzer), alleging that, between 1999 and 2004, Schnitzer's foreign subsidiary, SSI Korea, paid managers of government-controlled steel mills in China more than \$1.8 million in illegal payments to induce them to purchase scrap metal

from Schnitzer. To settle the civil charges brought by the SEC, as well as criminal charges brought by the DOJ, Schnitzer and SSI Korea paid a total of \$15.2 million.

In 2005, the San Francisco office charged InVision Technologies, Inc. (InVision), a Newark, California-based manufacturer of explosive detection machines used in airports, with authorizing improper payments to foreign government officials. The SEC alleged that senior employees of InVision were aware of a high probability that, in China, Thailand, and the Philippines, its foreign sales agents and/or distributors were making payments to foreign officials to secure or retain business. In addition, the SEC alleged that InVision allegedly improperly recorded payments to agents and distributors and failed to devise and maintain a system of internal controls. In the context of a merger, InVision disclosed the violations to the DOJ and SEC. InVision's settlements with the two agencies resulted in over \$1.9 million in disgorgement and penalties.

### **Unique Considerations for Companies Operating in China**

As technology companies focus on new business opportunities in China and meeting the rising demand for their products overseas, ensuring FCPA compliance requires constant diligence. The business environment in China is heavily regulated, and third party intermediaries are commonly engaged to ease navigation of the labyrinthine regulations. As a result, direct and indirect interaction with government officials takes place in far more areas than many business leaders, compliance officers or in-house counsel generally imagine. Some frequent examples include importing computer equipment and engaging a customs agent, applying for a work permit for an expatriate and engaging a local sponsor, negotiating with the tax authorities over the tax basis for a newly established representative office, and engaging independent consultants to assist with making government filings or introductions for a company's sales team to government procurement personnel.

Given the highly regulated and high risk business environment in China, internal monitoring and auditing of compliance programs are essential. A recent exposé about one prominent U.S.-based technology company highlighted the ways in which this company's employees purportedly circumvented the company's internal controls and used third-party intermediaries to provide extra benefits to hospital personnel.<sup>5</sup> Reportedly, in order to win bids against comparable competitors with comparable bidding prices, more than 100 employees, including at least one senior executive, were involved in schemes using third-party intermediaries to provide "special needs" to hospital personnel which the hospital personnel dictated in order for the company to win bids. The company salespeople hid the "special needs," namely "relevant training," which consisted of junkets for hospital personnel to overseas destinations, by using falsified documentation from the third parties, which the company salespeople would then confirm as "truthful" and "accurate."

The compliance issues in China are complicated by its deeply rooted tradition of gift giving and "guanxi" – the complex dance of business courtesies and hospitality that forms the social foundation for conducting business.<sup>6</sup> Although not always unlawful, gift giving and exchange of favors raise significant FCPA legal risks, as well as possible violations of local laws. Indeed, a majority of China-related enforcement actions involve gift-giving or entertainment expenses.

Also, while the FCPA only applies to improper payments to "foreign officials," whether an individual constitutes a "foreign official" is an exceedingly difficult issue in China. The Chinese government's significant ownership and control of commercial and industrial organizations leads to broad categories of individuals who constitute "foreign officials" under the FCPA. For example, procurement officials or IT professionals employed by state-owned hospitals are deemed "foreign officials" under the FCPA. Similarly, employees of construction companies, banks, oil and steel companies, and media outlets often qualify as "foreign officials," based on the

Chinese government's control or ownership of the company. The Chinese government is believed to be the majority shareholder of more than 30% of Chinese publicly traded companies.

Companies covered by the FCPA which do business in China should take into account a number of considerations. Although industry practice is not a valid defense to an FCPA violation, local law and customary practice are factors which may provide some guidance. Like the FCPA, Chinese law prohibits providing PRC government officials and/or certain top officials of state-owned enterprises with "money, property, fees or kickbacks" to obtain an improper advantage.<sup>7</sup> It is also a criminal offense for private commercial parties (which include the rank-and-file employees of state-owned enterprises) to provide or receive money or property of "relatively high value" to procure an improper advantage.<sup>8</sup> Local regulations limit the value of gifts to CNY200 (approximately USD30), which likely would be considered reasonable under the FCPA, provided that the gift-giver does not attempt to bypass the threshold by giving a large number of gifts each valued at CNY200.

## Conclusion

With the establishment of the SEC's new FCPA team in San Francisco, Silicon Valley

companies operating in Asia must be more vigilant than ever in ensuring compliance with the FCPA. While the unique characteristics of the Chinese gift-giving culture, in particular, add a layer of complexity to doing business, the Veraz settlement reinforces the need for corporations to design and maintain vigorous compliance programs to prevent FCPA violations from arising.

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<sup>1</sup> Dexter Roberts, *The Higher Costs of Bribery in China*, Bloomberg Businessweek, Jul. 8, 2010, available at [http://www.businessweek.com/print/magazine/content/10\\_29/b4187011931530.htm](http://www.businessweek.com/print/magazine/content/10_29/b4187011931530.htm).

<sup>2</sup> Enforcement Action, <http://www.complianceweek.com/blog/carton/2010/05/19/sec-opens-fcpa-unit-in-san-francisco/> (May 19, 2010, 22:03 EST).

<sup>3</sup> Enforcement Action, <http://www.complianceweek.com/blog/carton/2010/05/19/sec-opens-fcpa-unit-in-san-francisco/> (May 19, 2010, 22:03 EST).

<sup>4</sup> SEC Charges California Telecommunications Company With FCPA Violations, Litigation Release No. 21581 (June 29, 2010), available at <http://www.sec.gov/litigation/litreleases/2010/lr21581.htm>.

<sup>5</sup> Because hospitals in China are state-controlled, all hospital personnel are considered "foreign government officials" under the FCPA.

<sup>6</sup> Lesli Ligorner & Barbara Tsai, *The Chinese Puzzle Box: The Conundrum of Distinguishing a Permissible Gift from an Illegal Bribe*, China Matters (June 2010), available at [http://paulhastings.com/assets/publications/1612.pdf?wt.mc\\_ID=1612.pdf](http://paulhastings.com/assets/publications/1612.pdf?wt.mc_ID=1612.pdf).

<sup>7</sup> PRC Criminal Law (revised and promulgated by the National People's Congress on Mar. 14, 1997 and effective on Oct. 1, 1997), arts. 163 and 164.

<sup>8</sup> PRC Anti-Unfair Competition Law (promulgated by the Standing Committee of the National People's Congress on Sept. 2, 1993 and effective on Dec. 1, 1993), art. 8.

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