

MITIGATING FCPA RISKS WHEN DOING BUSINESS IN CHINA

By *Daniel Margolis** and *Brent Carlson***

INTRODUCTION

The People's Republic of China (PRC) has transformed its once entirely state-run socialist economy into an attractive and highly competitive global market, which today comprises the world's second largest single-country economy after the United States. In response, businesses and investors have flocked to the PRC. Those seeking to take advantage of the PRC's myriad opportunities, however, need to be familiar with the prohibitions of the Foreign Corrupt Practices Act¹ (FCPA). Broadly, the FCPA bans U.S. companies, or those listed on a U.S. exchange, from bribing or giving anything of value to a "foreign official" to obtain or retain business. Despite liberalization of the PRC's economy, many companies in the PRC remain largely state-owned. Any employee of a state-owned company may be considered a "foreign official" for purposes of the FCPA. Doing business in China requires extensive interaction with government agencies for project approvals, business licensing and regulatory compliance, so the opportunities for problematic behavior are plenty. In addition, the PRC has a deep-seated tradition of gift giving and entertainment as an acceptable, if not required, means of conducting business.

The confluence of these factors creates a particularly dangerous minefield for FCPA violations, which can result in penalties reaching into the millions of dollars. Unless special attention is paid to this issue, U.S. companies and investors should assume that FCPA violations are occurring at their China operations and by their acquisition targets. Consequently, companies considering investing or doing business in the PRC need to be cognizant of and guard against FCPA liability by performing

* *Daniel R. Margolis is a partner in the litigation department in the New York office of Pillsbury Winthrop Shaw Pittman LLP where he focuses his practice on white collar defense and corporate investigations. He is a member of Pillsbury's Foreign Corrupt Practices Act Task Force, which includes attorneys resident in Pillsbury's Shanghai office. Mr. Margolis previously served as an Assistant United States Attorney in the Southern District of New York, Major Crimes Unit. Both as a prosecutor and in private practice, Mr. Margolis handled many international criminal and regulatory investigations. He can be reached at (212) 858-1758 or daniel.margolis@pillsburylaw.com.*

** *Brent C. Carlson is a director with AlixPartners where he helps companies and their stakeholders in the areas of internal investigations, dispute consulting, operational improvement, restructuring & turnarounds, and interim management. Mr. Carlson has fifteen years of China business experience and has served in a number of senior management roles of foreign-invested operations. Mr. Carlson is fluent in both written and spoken Mandarin Chinese. In internal investigation matters, Mr. Carlson's experience includes matters related to embezzlement, kickbacks, conflicts of interest, fraudulent financial reporting, and the Foreign Corrupt Practices Act. He can be reached at (650) 483-5086 or bcarlson@alixpartners.com.*

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1. 15 U.S.C. §§ 78m, 78dd-1 – 78dd-3, 78ff (1998).

adequate due diligence and establishing an effective compliance program.

THE FCPA: OVERVIEW

Originally enacted in 1977, the FCPA prohibits corrupt payments to foreign officials for the purpose of obtaining or retaining business.² While initially this prohibition only applied to U.S. persons and business entities, since 1998³ the anti-bribery provisions also apply to the actions of foreign firms and persons within the U.S. In addition to the anti-bribery provisions, the FCPA's accounting provisions require companies whose securities are listed in the U.S. (Issuers) to keep accurate records and maintain an adequate system of internal controls.⁴

Accounting Provisions

The FCPA accounting provisions⁵ seek to ensure that Issuers comply with good accounting principles. There are two core obligations: first, the Issuer must maintain accurate and reasonably detailed books and records, and second, the Issuer must implement and maintain a system of controls to ensure that payments are authorized and recorded. The U.S. government need not prove unlawful intent to establish a violation of these provisions; mere negligence will suffice. The Securities and Exchange Commission (SEC) enforces the accounting provisions which generally carry only civil liability. If, however, the accounting provisions are knowingly circumvented or any books or records are intentionally falsified, criminal liability will attach.

Anti-Bribery Provisions

The anti-bribery provisions⁶ prohibit any firm or “any officer, director, employee or agent . . . or stockholder thereof” from corruptly offering to pay, promising to pay or authorizing payment of any money or anything of value to “any foreign official for purposes of influencing any act or decision” in order to obtain or retain business.⁷ Thus the FCPA prohibition applies to *any* individual, firm, officer, director, employee, agent or stockholder acting on behalf of a firm. For three types of actors—natural citizens, firms headquartered in or organized under the laws of a state of the U.S., and Issuers—actions taken not only within the U.S. but also abroad may violate the FCPA. Further, a foreign firm may be

2. *Id.* at §§ 78dd-1 – 78dd-3.

3. In 1997 the U.S. and thirty-three other countries signed the OECD Convention on Combating Bribery of Foreign Public Officials in International Business Transactions; this was ratified and implementing legislation enacted by Congress in 1998.

4. 15 U.S.C. § 78m.

5. *Id.*

6. 15 U.S.C. §§ 78dd-1 – 78dd-3.

7. *Id.* at § 78dd(a).

held liable if it causes a corrupt payment to occur within the U.S. either directly or via an agent. Finally, and perhaps most importantly, the FCPA prohibits payments to intermediaries, such as a subsidiary, agent or representative, knowing the payment will be made to a foreign official. “Knowing” includes not only actual knowledge, but also conscious disregard and deliberate ignorance. Thus a foreign subsidiary, agent or representative may incur liability for a U.S. firm if adequate steps to ensure compliance are not taken.

In order for a violation to occur, the payments must be made to a foreign official, a foreign political party or party official, or any candidate for foreign office. A foreign official is defined as “any officer or employee of a foreign government or any department, agency, or instrumentality thereof . . .”⁸ While the corrupt payment must be intended to cause the recipient to misuse his rank or position, the FCPA applies regardless of such rank or position. Specifically, if corrupt intent is present, the fact that the desired ends were not achieved is not a defense; an offer or promise of money or something of value still violates the FCPA. Finally, the FCPA does not merely apply to payments of money; it also may apply to gifts, travel, or even disclosure of proprietary information. There are no materiality thresholds for either the accounting or anti-bribery provisions.

The FCPA contains one exception for “grease” or “facilitating” payments⁹ as well as two affirmative defenses.¹⁰ In order for grease payments to fall within the exception they must be made to facilitate or expedite “routine governmental action[s]” that are ordinarily and commonly performed by a foreign official. Examples include obtaining certain routine permits or licenses, processing governmental papers, providing police protection, mail services, utility services, and loading, inspecting, storing or transporting cargo. The affirmative defenses are: (1) the action was lawful under the written laws of the foreign country; and (2) the action was a reasonable and bona fide expenditure related to promotion of a product or performance of contractual obligations. Any expenditure believed to be subject to either affirmative defense should be properly authorized and documented.

*Anti-Bribery Enforcement & Penalties*¹¹

The Department of Justice (DOJ) is responsible for all criminal and civil enforcement, except for civil claims related to Issuers, which are handled by the SEC. In criminal actions, individuals may be personally fined up to \$100,000 and may not be indemnified or reimbursed by their employer. Individuals may also be sentenced up to five years in prison for

8. *Id.* at §§ 78dd-1(f)(1), 78dd-2(h)(2), 78dd-3(f)(2).

9. *Id.* at §§ 78dd-1(b), 78dd-2(b), 78dd-3(b).

10. *Id.* at §§ 78dd-1(c), 78dd-2(c), 78dd-3(c).

11. *Id.* at §§ 78dd-2(g), 78dd-3(e), 78ff.

each offense. In criminal proceedings, a company may be fined up to \$2,000,000 per count, held accountable for the costs of litigation, and fined an amount equal to twice the benefit sought to be obtained by the corrupt payment. Civil actions carry fines, for the firm *and* any individual involved, of up to \$10,000 plus an additional amount at the court's discretion. Civil actions may also be brought to enjoin future violations. If a violation of the FCPA is found, the person or firm may also face any of the following consequences: (i) suspension of the right to do business with the federal government; (ii) ineligibility to receive export licenses; (iii) suspension from securities business by the SEC; (iv) suspension or debarment from the Commodity Futures Trading Commission or Overseas Private Investment Corporation; and (v) tax ramifications because illegal payments are not deductible as business expenses. Finally, a private cause of action is available under the Racketeer Influence and Corrupt Organizations Act,¹² which permits recovery of treble damages. Thus, liability under the FCPA may be multifaceted and staggering. For example, in a recent settlement, Baker Hughes agreed to pay the DOJ and the SEC an aggregate of \$44 million in fines and was required to retain a monitor for three years.¹³ More recently, in May 2008, Willbros Group Inc. agreed to pay more than \$32 million in fines, penalties, disgorgement and interest in DOJ and SEC actions.¹⁴

RECENT ENFORCEMENT ACTIONS INVOLVING CONDUCT IN THE PRC

Over the last several years, several U.S. companies disclosed that they resolved, or were the subject of, government investigations into alleged FCPA violations in China. For example, in December 2007, Lucent Technologies Inc. resolved FCPA investigations by the DOJ and the SEC by paying a \$2.5 million fine.¹⁵ The government had alleged that certain purported promotional expenses were actually vacation trips for more than three hundred PRC officials. While there is an affirmative defense for promotional payments, Lucent did not accurately record these payments and it could not show the payments were directly related to a legitimate business purpose. While the trips were characterized as "factory inspections" or "training," they typically consisted primarily of sightseeing to "locations such as Disneyland, Universal Studios [and] the Grand Can-

12. 18 U.S.C. §§ 1961-68 (2006).

13. \$23 million was paid for disgorgement and prejudgment interest, \$10 million for a civil penalty, and \$11 million for a criminal fine. *See* Baker Hughes Inc., SEC Litigation Release No. 20094 / SEC Accounting and Auditing Enforcement Release No. 2602 (April 26, 2007), *available at* <<http://www.sec.gov/litigation/litreleases/2007/lr20094.htm>>.

14. Willbros Group Inc. Enters Deferred Prosecution Agreement and Agrees to Pay \$22 Million Penalty for FCPA Violations, Department of Justice Press Release No. 08-417 (May 14, 2008), *available at* <<http://www.usdoj.gov/opa/pr/2008/May/08-crm-417.html>>.

15. Lucent Technologies Inc. Agrees to Pay \$1 Million Fine to Resolve FCPA Allegations, Department of Justice Press Release No. 07-1028 (December 21, 2007), *available at* <http://www.usdoj.gov/opa/pr/2007/December/07_crm_1028.html>.

yon.”¹⁶ Lucent acknowledged that these trips were “requested and approved with the consent and knowledge of the most senior Lucent Chinese officials.”¹⁷

Also in December 2007, the CEO of Schnitzer Steel Industries, Inc., Robert W. Philip, individually agreed to pay more than \$250,000 to settle FCPA charges related to his approval of a subsidiary’s cash payments and gifts to officials of state-owned steel mills.¹⁸ This is in addition to the more than \$15 million paid by Schnitzer Steel Industries, Inc. in October 2006 to settle related charges with the DOJ and SEC.¹⁹

In September 2007, Paradigm B.V. announced an agreement with the DOJ to pay a \$1 million penalty after it discovered during due diligence that its agent in the PRC had made improper payments to representatives of a subsidiary of the China National Offshore Oil Company.²⁰ Paradigm also agreed to implement rigorous internal controls and retain compliance counsel to protect against future violations. This case illustrates the fact that in the PRC even a representative of a subsidiary of a state-owned company can constitute a “foreign official” for the purposes of the FCPA.

These are merely a few of the current FCPA actions and investigations involving the PRC that have been reported; others include firms such as Siemens AG,²¹ Faro Technologies, Inc.,²² York International

16. *Id.*

17. *Id.*

18. SEC Charges Former Chairman / CEO of Schnitzer Steel for Authorizing Cash Bribes to Foreign Officials, *Securities and Exchange Commission v. Robert W. Philip*, Case No. CV-07-1836, SEC Litigation Release No. 20397 (December 13, 2007), *available at* <<http://www.sec.gov/litigation/litreleases/2007/lr20397.htm>>. In addition, the former Executive Vice President and head of the Schnitzer subsidiary Si Chan Wooh also individually agreed to pay approximately \$40,000 in disgorgement, interest and penalties for the same violation. SEC Settles Charges against Former Portland Steel Executive for Anti-Bribery Statute Violations, *SEC v. Si Chan Wooh*, Case No. CV-07-957 ST., Litigation Release No. 20174 (June 29, 2007), *available at* <<http://www.sec.gov/litigation/litreleases/2007/lr20174.htm>>.

19. Schnitzer Steel Industries Inc.’s Subsidiary Pleads Guilty to Foreign Bribes and Agrees to Pay a \$7.5 Million Criminal Fee, Department of Justice Press Release 06-707 (October 16, 2006), *available at* <http://www.usdoj.gov/criminal/pr/press_releases/2006/10/2006_4809_10-16-06schnitzerfraud.pdf>. Securities Exchange Act of 1934 Release No. 54606 / SEC Accounting and Auditing Enforcement Release No. 2493 (October 16, 2006), *available at* <<http://www.sec.gov/litigation/admin/2006/34-54606.pdf>>.

20. Paradigm B.V. Agrees to Pay \$1 Million Penalty to Resolve Foreign Bribery Issues in Multiple Countries, Department of Justice Press Release No. 07-751 (September 24, 2007), *available at* <http://www.usdoj.gov/opa/pr/2007/September/07_crm_751.html>.

21. *See* Siemens Earnings Release for Fiscal Year 2007 and attached document, “Legal Proceedings – Fiscal 2007,” (November 8, 2007), *available at* <<http://w1.siemens.com/en/investor/index.htm>> (detailing the legal proceedings and investigations around the world regarding allegations of public corruption).

22. Faro Technologies Agrees to Pay \$1.1 Million Penalty and Enter Non-Prosecution Agreement for FCPA Violations, Department of Justice Press Release No. 08-505 (June 5, 2008), *available at* <<http://www.usdoj.gov/opa/pr/2008/June/08-crm-505.html>>.

Corp.,²³ InVision Technologies, Inc.,²⁴ Diagnostic Products Corp.²⁵ and AGA Medical Corporation.²⁶

GENERAL FACTORS RAISING FCPA RISK IN THE PRC

Doing business in the PRC raises unique risks of FCPA violations. First and foremost, in the PRC “foreign officials” is a sweepingly broad group, including all officers and employees of state-owned or controlled companies as well as all Communist party members. Today, many businesses in the PRC are still either wholly or partially state-owned or controlled, particularly in the automotive, banking and financial, chemical, construction, energy (including oil and gas) and telecommunications industries. Thus, there is a significant chance that a U.S. firm’s customers and business associates in the PRC will be considered foreign officials for purposes of the FCPA, even though the company does not recognize them as such.

Various additional factors, such as cultural mores, historic business practices and operational hurdles, increase the risks of FCPA violations. In Chinese culture, the tradition of gift giving and entertaining as a sign of respect runs deep. Traditionally, when entering into a new business relationship, the party in the weaker bargaining position sought to woo the other party to the negotiation table with gifts and/or entertainment. Given the many levels of bureaucracy in many PRC companies, gift giving occurs at various levels of management. Further, across various industry sectors, providing kickbacks is a standard business practice.

Despite the immense competitive pressure and perception that “everyone is doing it,” if a U.S. firm engages in these types of actions, the FCPA is immediately implicated. Even if the U.S. firm does not directly

23. Justice Department Agrees to Defer Prosecution of York International Corporation in Connection with Payment of Kickbacks Under the U.N. Oil For Food Program, Department of Justice Press Release No. 07-783 (October 1, 2007), *available at* <http://www.usdoj.gov/opa/pr/2007/October/07_crm_783.htm>; *see also*, SEC Files Settled Foreign Corrupt Practices Act Charges Against York International Corporation For Improper Payments to UAE Officials, to Iraq Under the U.N. Oil For Food Program, and to Others - - Company Agrees to Pay Over \$12 Million and to Retain an Independent Compliance Monitor, U.S. Securities and Exchange Commission, Litigation Release No. 20319 (October 1, 2007), *available at* <<http://www.sec.gov/litigation/litreleases/2007/lr20319.htm>>.

24. InVision Technologies, Inc. Enters Into Agreement With the United States, Department of Justice Press Release No. 04-780 (December 6, 2004), *available at* <http://www.usdoj.gov/opa/pr/2004/December/04_crm_780.htm>.

25. DPC (Tianjin) Ltd. Charged With Violating The Foreign Corrupt Practices Act, Department of Justice Press Release No. 05-282 (May 20, 2005) *available at* <http://www.usdoj.gov/opa/pr/2005/May/05_crm_282.htm>; *In re Diagnostic Products Corporation*, SEC Accounting and Auditing Enforcement Releases, AAER-2249 (May 20, 2005).

26. AGA Medical Corporation Agrees to Pay \$2 Million Penalty and Enter Deferred Prosecution Agreement for FCPA Violations, Department of Justice Press Release No.08-491 (June 3, 2008), *available at* <<http://www.usdoj.gov/opa/pr/2008/June/08-crm-491.html>>.

make such payments, there is the danger that local agents or representatives may make improper payments of their own volition. In practice, local agents, representatives, or domestic joint venture partners are often used to penetrate the market because of restrictions on foreign investment in the PRC and also because U.S. firms may not know the local market, language or customs. However, the U.S. firm cannot turn a blind eye to these practices; it can still be held liable under the FCPA as if it took the prohibited action itself.

CONDUCTING AN FCPA RISK ASSESSMENT AND INSTITUTING A COMPLIANCE PROGRAM

Before conducting business in the PRC, a prudent first step is to conduct a baseline risk assessment to determine any FCPA exposure. The DOJ has outlined a number of “red-flags” that U.S. firms should look for when conducting business abroad including “unusual payment patterns or financial arrangements, a history of corruption in the country, a refusal by the . . . [counterparty] to provide certification that it will not take any action . . . in violation of the FCPA, unusually high commissions, lack of transparency in expenses and accounting records,” and finally, whether the counterparty “has been recommended by an official of the potential governmental customer.”²⁷ Other key areas of concern include sales and marketing expenses, travel expenses, entertainment expenses, employee records and hiring of ghost employees, and any use of consultants and agents.

In China, the risk of a company encountering FCPA problems often depends largely on the industry sector in which it operates. China places each industry sector into one of four categories as they relate to foreign investment: encouraged, permitted, restricted and forbidden. Generally, the more restrictions China places on foreign investment in the industry, the greater need for controls to guard against the pressure companies feel to make corrupt payments in order to secure government approval.

The risk assessment should, among other things, identify all aspects of the business that involve foreign officials and state-owned enterprises, identify those employees who deal with foreign officials, identify all agents and consultants, and analyze any existing internal controls and compliance policies. Once the relevant risks have been identified, creation of an effective FCPA compliance program is advisable. Such a program may include procedures and guidance for dealing with foreign officials, foreign sales representatives and consultants; employee training sessions and informational handouts in the local language; implementation of policies and procedures to ensure accounting accuracy; written certification by relevant employees and foreign representatives acknowledging receipt, understanding and willingness to follow policies; effective

27. Fraud Section, U.S. Dep’t of Justice, Lay-Person’s Guide to FCPA, *available at* <http://www.usdoj.gov/criminal/fraud/docs/dojdocb.html>.

reporting mechanisms for violations; procedures for investigating possible violations; and ongoing internal audits and compliance assessments.

As stated above, there are no materiality thresholds built into the FCPA. That is, there is no minimum transaction size or bribe amount below which the FCPA would not apply. As a practical matter, therefore, even though a local company may have audited financial statements, unless the auditor specifically tests for FCPA compliance, potential violations can easily be missed.

External monitoring and compliance companies may assist with identifying risk, establishing internal controls, and performing periodic audits. In addition, the DOJ has established an FCPA Opinion Procedure²⁸ under which any U.S. company may request an opinion from the Attorney General regarding specific conduct. Generally, the Attorney General will issue an opinion within thirty days indicating whether the conduct might violate the FCPA. If the opinion confirms the conduct does not run afoul of the FCPA, such conduct will be granted a presumption of conformity in any subsequent enforcement action.

AREAS OF CHINA OPERATIONS AT HIGHER RISK FOR FCPA VIOLATION

In our experience, the following areas present recurring risks for FCPA violations. Companies would be well advised to address these areas in any risk assessment and compliance program.

Agency Relationships. As awareness of FCPA issues has increased, many companies in China have begun to filter their payments to government officials through consultants and other third-party agents. Careful review of the relationships and agreements with these agents is, therefore, necessary to ensure full FCPA compliance. U.S. companies should, whenever possible, avoid commission-based contracts with agents or representatives in China. In addition, agency agreements should include an undertaking by the agent to refrain from any action that would cause the U.S. company to be in violation of the FCPA. Any expenditure by the agent should be subject to approval and properly documented. Finally, the U.S. firm should ensure that the agent is aware of the FCPA risks by providing guidance and compliance guidelines in Chinese as well as English.

Acquisitions. Given the increased interest by foreign investors in China, M&A activity is expected to steadily increase in the coming years. FCPA violations, however, are not always uncovered—or necessarily looked for—in standard M&A due diligence. FCPA-specific due diligence that should be performed includes: analysis of the target business and its customers; interviews with employees, agents and consultants to understand

28. See Foreign Corrupt Practices Act Opinion Procedure, 28 C.F.R. § 80 (1999). Past Opinion Procedure Releases are available at <<http://www.usdoj.gov/criminal/fraud/fcpa/opinion/frgncrpt.html>>.

their business model; evaluation of existing internal controls; analysis of the target company's books, records and accounts; review of all contracts between target company and any agents; and perhaps most importantly, an evaluation of any relationships between the target company and any state-owned enterprises.

Employee Matters. Operations in China are characterized by a high degree of employee turnover and growth in the absolute number of employees. These facts present challenges for maintaining effective FCPA compliance training and monitoring. They also create the risk of "ghost employee" schemes in which bogus employee names are used as conduits for payments, ostensibly in the form of payroll. These funds can then be used for corrupt payments, among other things. The risk is exacerbated by the fact that in many Chinese companies, the Human Resources department maintains detailed and highly confidential (even for investors) information on employees, which is rarely subject to audit. Often, foreign owners do not even know employees by their real names, but only by English aliases. Foreign owners or investors, therefore, need to seek full access to company records from the outset.

Vendor/Third-Party Approval Process. It is common for Chinese companies to utilize a large number of vendors that have not been thoroughly vetted. This can result in undisclosed conflicts of interest on the part of company management who may be doing business with vendors they control through a spouse or other relative. Familial relationships can be difficult to discover in China as spouses do not share the same surname. The ability to pass payments through third-party vendors creates the risk both of corrupt payments to officials as well as false corporate books and records.

Tax Receipts. Many companies in China use bogus tax receipts in order to reduce their taxable income. The general purpose of this practice is to make cash transactions more difficult to trace and therefore subject to tax. This practice raises concerns both for tax liability in China as well as FCPA books and records liability in the U.S.

Media Representatives. Because most of the media outlets in the PRC are wholly owned by the state, any payments to media representatives to attend press conferences, a common practice in China, raise potential FCPA concerns. In July 2008, TRACE International, Inc., an organization specializing in, among other things, anti-bribery initiatives, sought an opinion from the DOJ regarding payments it sought to make to journalists to cover an anti-corruption conference.²⁹ The DOJ responded in Opinion Procedure Release 08-03 that on the facts presented by TRACE,

29. See DOJ Opinion Procedure Release 08-03 (July 11, 2008) available at <http://www.usdoj.gov/criminal/fraud/fcpa/opinion/2008/0803.html>.

payment of the specified stipends and transportation and lodging costs did not run afoul of the FCPA. The DOJ found that the payments fell under the affirmative defense covering expenses relating to the “promotion, demonstration or explanation of [TRACE’s] products or services.” The DOJ specifically noted that in reaching this conclusion, it did consider whether it was common practice in the PRC to provide benefits to journalists to attend press conferences. Therefore, companies intending to pay stipends and expenses to journalists in the PRC should read Opinion Procedure Release 08-03 carefully and ensure that, on the facts of the specific case, the payments fall within the affirmative defense.

Large Cash Advances. The credit card market is still developing in China. Especially in areas outside the main metropolitan centers, cash is often the only means of payment. Companies in China, therefore, commonly issue large cash advances to employees, especially those who travel often to such areas. These payments need to be strictly monitored as part of an effective FCPA compliance program. Large cash advances can easily be used to pass payments to consultants with less scrutiny than the accounts payable department would require.

CONCLUSION

The PRC has become an integral part of the global economy and, as such, U.S. firms have understandably sought to invest there. While the risks of FCPA violations in the PRC are quite real, they are not insurmountable. China ranks 72nd out of 179 countries in Transparency International’s 2008 Corruption Perceptions Index (tied with Mexico and Peru, and higher on the list than Morocco).³⁰ While corruption certainly does exist, the perception of corruption may be greater than the reality. With the proper internal controls, policies and procedures, companies can take full advantage of the burgeoning opportunities in the PRC without running afoul of the FCPA.

30. See http://www.transparency.org/policy_research/surveys_indices/cpi/2008.