Almost every major fraud or corruption crisis faced by multinational companies in the past year in China has involved whistleblower activity – former and disgruntled employees, suppliers, distributors, consumers, scammers and competitors are common sources of complaints, some legitimate, others not. China regulators and officials have publicly stated that 80% of anti-corruption investigations are initiated by whistleblowers.¹

Historically, whistleblower complaints have been logged internally with senior management and subject to internal investigations, but there has been a significant trend towards reporting (or threatening to report) directly to Chinese regulators. Whistleblowers are discovering the power of involving regulatory authorities in China to help them achieve their objectives, which range from reporting and rectifying a genuine integrity and governance issue, to extortive attempts to extract monetary or other concessions from management, or simply to take ‘revenge’ following disputes. In the new, turbo-charged China environment for regulatory oversight, such whistleblowers represent a significant source of risk for MNCs.

What’s changed?

There are several market dynamics that are creating the perfect storm of opportunity for whistleblowers in China:

*Rampaging regulators:* Despite less media attention in recent months, the trend in increasing regulatory oversight and enforcement since 2013 is *not* slowing down. Regulators that were quite passive in the past will maintain their more active and aggressive stance.² MNCs are on their collective radars. China’s political leadership has provided a mandate for regulator activity and we will continue to see high levels of enforcement, particularly in the key sectors of healthcare, automotive and consumer products, with likely increasing enforcement in energy, telecoms, infrastructure and real estate.

*Entrenched employees:* The slowdown in the Chinese economy means: (i) companies are not hiring aggressively and employees find it harder to seek alternative employment; and (ii) MNCs are restructuring commercial agreements with distributors and suppliers who are feeling the squeeze on their own business. This, in turn, has increased the *motivation* of employees and third parties to leverage information of potentially unethical or illegal activity. Threatening to blow the whistle to regulatory authorities is an often-successful way for them to retain their positions, *even if* they are complicit in the activity they are threatening to report.

*Inconsistent investigators:* Chinese regulators, under political pressure to deliver results, will often treat a whistleblower allegation like a “treasure map”. In many cases they are under pressure from the whistleblower, the media and their own peers to resolve a case with a finding against an MNC, regardless of the legitimacy or accuracy of the claims being made; within agencies, investigators have pressure and targets from their bosses. They will often confront the company with allegations taken verbatim from a whistleblower letter. Don’t expect regulators to do much diligence on an allegation before using it.

¹ From statistics provided by prosecutors at a Shanghai Bar Association seminar in November 2014
² The State Administration of Industry and Commerce (SAIC), the National Development and Reform Commission (NDRC), State Authority on Taxation (SAT) and the State Food & Drug Administration (SFDA) are among the most aggressive.
So how does this manifest itself?

Companies will often be approached by a mid-level regulator with vague allegations of “impropriety”. The company might be told that “we have information that one of your distributors is taking bribes” and will be asked to investigate themselves and report back to the authorities on their findings. The company will not be shown any specific evidence nor will they be given any legal basis for the regulator’s suspicion – but will often be threatened with legal or administrative action if they don’t cooperate (fines, loss of license, employee detentions, etc.). In many cases, regulators return the results of a company’s own investigation with additional ‘guidance’ on other areas to examine, until the company presents the desired investigative findings and evidence: this is often what is meant by ‘cooperating with the authorities’.

Effective responses

It is critical that a company think through the processes they use to accept and process whistleblower allegations. Best practice in China includes several key action items:

**Map the regulators:** Map the broad spectrum of regulators against your business scope and identify which regulators would be interested in what parts of your business. For example, if your operations rely heavily on third-party distributors to sell to customers, you will be vulnerable to allegations of bribery and corruption which would fall to local Administration of Industry and Commerce (AIC) offices to investigate. If you have a fragmented business structure in China with many sales offices, you could get called out on not paying the proper amount in local taxes, resulting in a State Administration of Tax (SAT) visit. For each type of allegation, identify which regulator might be interested, how active they are in each province you operate in, and understand what they look for and how they operate.

**Create a feedback loop to your China management:** Understandably, whistleblower allegations should be handled by a “neutral” party, not by the operation against whom the allegations are leveled. However, it is important that your China management know of the allegations so they can monitor the risk of whistleblowers reporting to local regulators. Too often, an office in China will be dealing with a regulator but have no idea that an allegation along similar lines was made to their head office hotline a few weeks earlier (one client had three different methods of handling whistleblowers). It is also critical to track allegations over geography and time. Companies who log and track the details of whistleblower complaints will often see patterns that can be dealt with, ahead of any regulator getting involved.

**Investigate outside the four walls:** All whistleblower allegations should be thoroughly investigated, however, a simple “audit” will not suffice. It is critical that a company look outside of their own books and records and trace the allegations back to activities of third-parties and entities outside of their company. Particularly if the allegations are around conflicts of interest or collusion, you will not find the evidence ‘inside your four walls’.

**Don’t concede to extortive demands:** If you have received an extortive threat to report information to a regulator, consider seriously whether you concede to any demands – it may seem like an effective short term solution, but there is a very high risk that it comes back to cause you bigger problems in future. There are many ways to be “cooperative” and you should consider all scenarios before responding.

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