In an era of aggressive enforcement and more demanding consumers in China, building a safe, sustainable, and reputable supply chain is more critical than ever. It takes a disciplined and unrelenting approach but one that will pay bottom-line and reputational dividends in the medium and long term. Today, the risks are simply too great not to act.

We have all heard the horror stories: Chinese children falling ill or dying from infant formula; Chinese employees working under dangerous environmental, health, or safety conditions; and injuries in other parts of the world to people poisoned by harmful ingredients found in construction materials and household goods manufactured in China.

Everyone in the supply chain can be open to blame—from the defective raw material supplier to the manufacturer of the defective end product. In between there are the shop floor personnel who flaunt quality or safety practices, procurement departments without an adequate supply chain program or resources, lax safety or product inspectors, and boards of directors who don’t hold the CEO and management accountable.

This report highlights key legal and compliance trends affecting the Chinese supply chain and suggests risk and reputation management guidelines for a successful approach to this complex and multifaceted task. It is relevant for multinational companies (MNCs)—those in China, those selling products and services within China, and those whose supply chain originates in China for distribution outside of China.
The Rapidly Changing Chinese Landscape

In recent months, national and international media have reported increasing awareness, activity, and government action related to supply chain issues within China. Government enforcement actions appear to be on the rise. The Chinese National Development and Reform Commission (NDRC) has been flexing its muscles in enforcing price fixing rules. The anti-corruption investigation into the pharmaceutical giant GlaxoSmithKline (GSK) seems to be one of the most expansive so far in China, including the arrests of local executives coordinated across several police offices in different cities, demonstrating a degree of coordination that is unusual. In addition, foreign owners of a risk management firm have been arrested for alleged misuse of personal private data. Reports and incidents, real or not, appear on Chinese social media frequently.

At the core of this trend and as a policy matter, Chinese government authorities have stated that they are focused on consumer protection issues and the broad public interest. Consistent with this approach, Chinese media have broadcast a variety of complaints, questioning the purity and testing of well-known bottled waters, food labeling integrity, and whether the nation’s pork supply is threatened.

Global media often focuses on generational changes taking place at the top leadership in China but a generational change is also happening within enforcement agencies. Younger, better-educated officials, some with international experience and many with broad exposure to a variety of information from the internet (as well as experience traveling or studying abroad) are moving up the ranks. Enforcement across different government offices in different jurisdictions in China is also on the rise. In the supply chain context, one could see a number of actions arising from one incident, including improper labeling, unfair competition, false advertising, and ancillary claims such as tax evasion, each of which would be led by a different regulatory agency. In short, the Chinese regulatory landscape is changing, the key players are becoming more sophisticated and motivated, and the public is increasingly willing to seek recourse for real or perceived injury.

Dealing with Crisis and Detention Threats

From time to time, media attention focuses on the detention of top corporate management. Under Chinese law, there is a legal basis for holding the “legal representative” or other responsible persons within a corporation liable for alleged corporate violations. The company itself may also be charged, if circumstances warrant. The risk of detention and arrest has heightened anxiety among both local and expatriate employees. The prospect of detention calls for adequate contingency planning, including “dawn raid” protocols, together with a response team that includes outside professionals—not just lawyers, but also a risk management team and a media team.

Detention or arrest requires a culturally informed approach by both the individual and the company involved. In most cases, and certainly in high-profile ones, a lengthy investigation will have preceded any detention or arrest. From the outset, then, one can expect government authorities to take a “where there’s smoke, there’s fire” approach. So when management is hauled in, they are expected to cooperate fully, be respectful and, where appropriate, demonstrate remorse. These factors, properly understood, can help mitigate a crisis. Improperly understood, miscommunication can lead to poorer outcomes for both the individuals affected (employees as well as third party consultants) and their companies.

In addition, Chinese consumers are ever more mindful of their rights. Media programs covering consumer rights play daily, both on television and radio. Perceived corporate wrongdoing may trigger unannounced visits by consumers to headquarters and even public agitation, sometimes rising to the level of a reportable “mass incident” (which roughly equates to a demonstration of some sort, although demonstrations, as such, are not permitted). Social media plays an increasingly key role in these situations as well. A rising count of whistleblower cases across a host of compliance issues is also encouraging consumers and others, including insiders, to air their claims and complaints. Managing these increasingly vocal constituencies calls for a more proactive approach to compliance concerns and violations and more effective monitoring programs.

Improving Supply Chain Management: Local and Legal Considerations

**Start with a solid contract** Managing supply chain risk starts with an understanding of the legal and regulatory framework. The core tool, of course, is the contract. The old adage of “say what you mean, and mean what you say” should apply with added force in Chinese supply contracts. It is not advisable to rely on courts or arbitrators to fill in the gaps. It is critical to be comprehensive, and specific—in both English and Chinese. This applies not only to specifications, delivery, and inspections; but also to remedies, penalties, compliance expectations, reporting obligations, and other aspects of the transaction. It is also important to be rigorous: the upfront investment of time and money will pay off in better contractual protections.

**Know with whom you are dealing, before signing** Background checks and corporate information are limited by regulatory restrictions, and aggressive tactics are increasingly likely to add to the degree of risk exposure. Recent developments have inhibited information gathering, both personal and corporate. With respect to background checks, a two-year campaign to protect personal data has now expanded to cover foreign-invested risk assessment operations, and the local offices that maintain company registration materials also have limited public access. Going beyond these limits with more aggressive service providers can backfire.

That being said, the Chinese market has been open for decades, and seasoned advisors can shed light on the mistakes of others (and there have been plenty of these). Seasoned specialists can include local experts with international exposure, international operations on the ground in China looking at labor and other practices, and others. However, in today’s environment, caution should always be exercised to ascertain whether specialist advisors are operating within the Chinese regulatory system: “check the checkers” to minimize risk.

**Know your workforce** Supply chain integrity relies on the workforce, starting at the shop floor level. Employment practices and workplace safety should be evaluated and assessed regularly. Suppliers with lackluster employment practices are more likely to cut other corners as well.

It is critical to instill a culture of compliance with vendors—one that rewards integrity and an open, transparent culture where people can speak up without fear or intimidation. It may cost a bit more up front to build this culture with a vendor, but will save much more in the long run by avoiding costly enforcement or consumer actions, poor quality shipments, or worse. At the end of the day, the best risk and reputation management begins with selecting the best people locally—in executive and management roles, business development roles and, critically for the supply chain, operational and shop-floor supervisory roles.

In China, this also requires a thorough understanding of employment laws and regulations and how those play out in the marketplace. Chinese rules are generally employee friendly, and those caught unaware of the rights and protections afforded to workers and staff may find themselves facing not only supply chain breakdowns, but additional costs of labor settlements, arbitration proceedings, lengthy litigation, and significant reputation risk.

**Set a high bar for your lawyers** When employing local counsel ensure they understand the company’s strategic plan and objectives, culture, and approach to ethics and are capable of translating those into workable policies, procedures, and protections in the Chinese business context. If crisis management comes into play, even with a detention or arrest, companies should not rely solely on Chinese counsel to implement strategy. Management should stay actively involved and communicate directly with the key regulators, rather than rely exclusively on counsel for direct interactions. Unlike many other jurisdictions, in many cases, it may be counterproductive to have counsel front the issues.

**Understand cross-border developments** The limits of personal jurisdiction will likely insulate a company or non-resident individual from a direct lawsuit, and in China, there is no equivalent of a class action. In addition, strict privity of contract rules generally means that only the direct contracting party can come after the company for an alleged failure to abide by the terms of a deal. Nonetheless, as plaintiffs and their advisors garner experience, and tort law develops, it is possible that a theory of negligent or reckless supervision may develop under Chinese law. Moreover, China is now party to more than 100 judicial assistance treaties, which to some extent facilitate cross-border cooperation in litigated matters—a company or individual may no longer be completely immune from a lawsuit or enforcement action at home that relates to a Chinese proceeding.

**No, not “everybody does it”** “Everybody does it…this is how China works,” or something along those lines is often said to justify behaviors. While perhaps not headline-grabbing news (unlike unethical or illegal behavior), there are numerous supply chain success stories where integrity is rewarded. One example is a publicly traded U.S. beverage
and beverage machine producer that sources nearly all of its key beverage machine products in China. It regularly holds supplier conferences and hands out awards (in the form of sought-after small consumer goods) for compliance achievements. Its inspectors are seen as mentors, not enforcers. Compliance achievements also translate directly into more orders in the next cycle for vendors. While risk and reward can vary across different sectors, rewarding those who demonstrate compliance and work to maintain integrity is a strategy for success that works to build the bottom line.

**Improving Supply Chain Management: Governance, Risk, Reputation Fundamentals**

When New Zealand-based Fonterra discovered the presence of botulism in some of its milk product ingredients headed for or already in China and several other countries in the summer of 2013, the company moved quickly to advise Chinese consumers and reign in its distribution chain. Doubtless, Fonterra had learned lessons from several other recent cases including the 2008 case of melamine-contaminated baby formula that reportedly killed six children (and sickened many others) in China. Melamine-tainted baby formula was eventually traced back to 22 producers—with Sanlu, 43 percent-owned by Fonterra, being one of the headline-grabbing offenders.

Building an effective supply-chain management program is a complex and highly customized undertaking. Every company has a different set of factors working for and against them, different products and services, and different geographical, industry, sourcing, procurement, and business plans and strategies. Getting it right on supply chain management begins at the top—the supply chain needs to have a place in management thinking, strategy, and board awareness.

Supply chain risk management is a microcosm of doing business generally. A typical supply chain is long, complex, multifaceted and to some extent unpredictable. It exhibits a breadth of risks and opportunities that are otherwise extant in the broader business context. Here’s a list of many of the possible sub-risks that relate to the overall supply chain:

- Third party (i.e., supplier, vendor, distributor, agent, consultant, venture partner, or partner)
- Labor and human rights (e.g., child labor, overtime, benefits, and other employment compliance concerns)
- Health and safety
- Ingredient/component and product quality/safety
- Private or public procurement
- Regulatory (specific to the industry in question)
- Private corruption or the kind of commercial bribery that takes place between non-governmental entities, e.g., company to company kickbacks
- Public corruption involving improper payments to governmental officials that is forbidden by local laws and extraterritorial laws such as the U.S. Foreign Corrupt Practices Act or the UK Bribery Act
- Fraud
- Misrepresentation/false advertising
- Environmental impact
- Climate change/sustainability impact (e.g., water, energy, other resource use)
- Money laundering
- Business continuity and crisis management

Supply chain fiascos may also stem from local, provincial, and national governments that:

- do not provide proper regulatory or licensing requirements;
- do not bother to enforce existing laws and regulations; and/or
- at worst, accept or demand bribes to look the other way.

Accordingly, companies need to be clearly aware of the government and regulatory requirements surrounding their supply chain and of the potential weak spots where corruption and bribery can occur.

A robust global supply chain program that addresses not only logistics, operations, and business continuity but also governance, risk and reputation, should exhibit the following fundamentals:

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Baseline risk assessment and continuous risk management Critically important to any company’s knowledge of its supply chain risks is the conduct of a baseline supply chain risk assessment and periodic testing. Knowing what the supply chain risks are informs the shape, tenor, and content of a supply chain risk management strategy.

Different companies will have differing needs—a food company or pharmaceutical company will have arguably a greater need for product ingredient safety and integrity than an automotive company purchasing car parts—but there are common programs that all companies need to include in their supply chain risk management repertoire, and each of these must be adapted to be effective in China and other key jurisdictions.

One corporate owner for overall supply chain risk Company procurement, operations, or another appropriate central department should own overall supply chain risk management, with the right budget, resources, and IT infrastructure to ensure logistics and regulatory compliance. No matter how decentralized a company is, for proper and effective risk management, supply chain management should be a function that is more centralized or centrally coordinated than most.

Cross-functional supply chain risk management team While one function “owns” supply chain risk, other functions (legal, compliance, finance, ethics, corporate responsibility, audit, operations) and business units should be part of a proactive cross-functional approach to supply chain risk management, crisis management, and crisis post-mortems. Depending on the company, such a proactive cross-functional approach to overall supply chain risk management may also benefit from the participation of functions such as public relations, government affairs, and marketing.

Clear global supply chain communications, policies, and training Whether specifically called supply chain or something else, the risks revolving around the supply chain need to be clearly identified in a company code of conduct, with examples and Q&A, training modules, and resources made available to employees with concerns or questions. These tools should also be rolled out locally in a way that makes them effective in the Chinese regulatory system. A critically important component of good supply chain risk management is to integrate supply chain crisis scenario planning exercises into a training program including and up to the board level.

Supply chain third party pre-screening Third parties—whether agents, vendors, suppliers, distributors, or others—should be subject to meaningful due diligence prior to entering into contracts. In the context of the Chinese marketplace, clear, contractually binding compliance provisions should be included. Ongoing obligations should include covenants around quality, labor, anti-corruption, anti-fraud, inspection rights, and audit rights. Whatever form this third party due diligence takes—whether through automated software programs or local records and information searches—companies and their advisors have to be very mindful of the legal minefields that exist and ensure that no laws are violated in the process.

It may no longer be good enough to simply check first-tier suppliers prior to entering into relationships with them. Increasingly best practices, common business sense, and governmental pressure (from the United States Department of Justice, for example) suggest that smart companies seeking to maintain their good reputations will undertake deeper due diligence that demands looking at second- and even third-tier suppliers. While there is no bright-line test for how deep in the supply chain one should go, at a minimum key materials and components should be covered as well as any permitted sub-contractors. All documentation should also cover this as well. Moreover, due diligence is not a one time occurrence but something companies need to undertake periodically especially for long-term supplier relationships to ensure continuing compliance and sustainability, as discussed further in the next section.

Third party checking, testing, and auditing Internal and external auditing, testing, and checking of third party facilities, ingredients, components, quality, safety, and labor rights practices need to be part of the deal. Companies with extensive supply chains and supply chain risk should consider having an internal supply chain risk auditing and monitoring team (as some successful garment companies have done) or developing part of their internal audit function to accomplish such ongoing and periodic tasks. These internal auditors should undertake continuous monitoring of suppliers and other aspects of their supply chain through software programs or through random periodic checks. Doing so will be critically important to ensuring compliance with contracts, regulations, and best practices.
Especially in light of some the supply chain tragedies that have occurred recently, including the Rana Plaza Bangladeshi building collapse that killed 1,100 garment workers, more responsible global companies are beginning to take a more thorough approach to managing third-party supply chain risk. Such an approach includes demanding that first-tier suppliers require on an ongoing basis the same standards and controls from their second- and third-tier suppliers as the company demands from them. This updated approach also involves the use of cooperation amongst companies in the same sector to share resources, tools, inspections, inspectors, audits, and auditors to go further into the supply chain and not just concentrate on the first tier. Requiring key performance metrics from first-, second-, and third-tier suppliers is another aspect of better supply chain management that is becoming more widespread. Innovative companies are also beginning to cooperate on pressuring local governments to do their part in enforcing laws and regulations that would uphold safety and environmental standards, for example.5

Speak-up culture about risks generally and supply chain risks specifically The C-Suite and management need to set the right tone from the top encouraging a “speak-up culture” on risks in general, including supply chain risks, from the shop floor to the executive suite and everywhere in between. A critical element in ensuring such an open culture that goes beyond mere statements in glossy brochures and intranet pages is to ensure that when concerns are raised they are publicly addressed. Employees of a company are the first to know whether the tone from the top is internal marketing or real policy—by whether management shows through action a commitment to real safety. Culture trumps compliance every time. A weak link in the supply chain can have the effect of bringing the whole chain down and with it the reputation of the company.

Board oversight and reporting Companies with major supply chains should make supply chain risk management part of the board risk agenda, whether at a committee-level quarterly or in an annual report to the full board. Boards, in turn, should demand accountability and reporting from senior management on this critical and complex risk. Chief risk, legal, compliance, ethics, and other officers should make sure to press the importance of these issues with their senior management and board to ensure that proper attention is paid and resources are devoted before the risk becomes a crisis.

Conclusion: Trust but Verify

No company can become the perfect supply chain manager with a risk-free environment. However, companies can equip themselves with a balanced approach that:

- takes firmly into account the risks of doing business in a particular location, including in and out of that location and others, and
- formulates the supply chain with the proper governance, risk, and reputation management checks and balances.

No supply chain risk management program, however, will be worth much without the commitment in resources, vocal and substantive support of senior management, and the demand by company directors of proof in the supply chain risk management “pudding” in the form of periodic reports and testing.

Effective supply chain risk management can be rewarding. By having such a program, not only will companies avoid the worst downsides of supply chain failure—injuries, accidents, product recalls, fines, incarceration, reputation loss, decline in shareholder value—they can also reap significant rewards, including business process improvements, cost efficiencies and savings; a safer, happier labor force; brand enhancement; and, in some cases, even product and service innovation. All of these rewards will spill over into an enhanced reputation, which in turn may even help drive consumer loyalty and a higher return on investment. Good ethics is good business.

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About the Authors

Andrea Bonime-Blanc, JD, PhD is CEO and founder of GEC Risk Advisory LLC, a strategic governance, risk, ethics, compliance, and corporate responsibility advisory firm to global companies and boards (http://www.gecrisk.com). Bonime-Blanc has two decades of international executive governance, legal, compliance, risk, internal audit, and corporate responsibility experience. Her experience includes private, public, established, and start-up companies in technology, media, infrastructure, utility, defense, manufacturing, and professional services. Bonime-Blanc is a director and chair emeritus of the ECOA, NACD member, life member of the Council on Foreign Relations, and a frequent speaker. She is the author of many books and articles and writes the monthly column, “The Global Ethicist,” (http://bit.ly/YHoGL7) for Ethical Corporation Magazine.

Michael Hickman is an international partner with Haiwen & Partners (www.haiwen-law.com), resident in the firm’s Shanghai office. Hickman has nearly thirty years of experience with China-related matters and transactions. He routinely advises leading multinational companies and financial institutions regarding a wide range of regulatory and compliance matters affecting their investments and operations in China, all involving full use of his bilingual and bicultural skills and experience. Hickman’s recent publications include articles discussing recent headline investigations, cross-border whistle-blowing developments, trends in Chinese corporate governance, and the extraterritorial effects of Chinese regulations (www.haiwen-law.com/haiwen_alerts).

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