

Research on the Practice Path of Corporate Compliance Based on the Perspective of Incentive Regulatory Theory

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Abstract: Corporate compliance is a popular topic with the construction of modern enterprise system. Achieving the compliance goal in a company is not only beneficial for the corporate governance, but also necessary for the development of healthy markets. Currently China has not established comprehensive corporate compliance system yet and been challenged during the process of trades with multinational companies. The public regulatory agencies mainly produce prohibitions to deter companies from violation or crime. The discussion about the practice path of corporate compliance explores the way of changing the traditional regulation into incentive regulation, which aims to encourage companies to establish compliance system actively.

1. Introduction

Literally speaking, the term “compliance” means observing the laws and regulations. The “laws and regulations” can be categorized into four types: (1) Laws, regulations, rules, local regulations and judicial interpretations promulgated by the authorities; (2) Business practices, including codes of conduct and ethical norms generally observed in the market; (3) Articles of association and rules formulated within a company; (4) International treaties [1].

Corporate compliance is also called “business compliance”, and it firstly appeared in the Financial Security Area. The U.S. has a relatively comprehensive compliance program. In order to prevent and punish companies’ illegal acts, the legislative departments have introduced a variety of regulatory measures to prohibit compliance risk and crisis. The purposes of corporate compliance are to deter the illegal behavior as well as to guide companies to comply with ethical norms. The sanction on Zhong Xing Telecommunication Equipment Corporation (ZTE) [2] in 2018 accused by violation of corporate compliance reminded Chinese companies of its importance.

Although legislation and regulation are implemented for corporate compliance, the effects do not always satisfy anticipation. The corporate internal operations depend on the joint efforts of various departments and personnel within a company, and whether the corporate business activities comply with regulations requires an external evaluation by a third party. In other words, achieving corporate compliance is inseparable from the corporate internal governance and external regulations. External supervision refers to the intervention of public power agencies or the evaluation of legal norms. How can the external regulations inspire the establishment of corporate compliance and realize the maximum of compliance is the topic of this paper.

2. The Development of Corporate Compliance: Changeable and Adaptable

As the participant of business affairs, companies are sensitive to the change of market and try to grasp profits and interests by all means even illegal ones. The regulation always works for remedy after the violations happened. For example, corporate giants such as Enron, WorldCom, Xerox, and Merck successively were detected financial fraud since 2002. The U.S. Congress then passed the *Sarbanes-Oxley Act* for improving the accuracy and reliability of corporate information disclosure through legislation. However, this kind of regulation is no longer fit into the development of corporate compliance and new path should be provided.

2.1 The Development Path of Corporate Compliance

From the perspective of comparative law study, the corporate compliance in the U.S. has experienced more than eighty years. According to its legal provisions, it is obvious that government has implemented loads of supervision and regulation in the aspects of antitrust and anti-corruption. And much attention is focused on the criminal violation. *U.S. Sentencing Commission Guidelines Manual* points out that criminal compliance aims to maintain an internal mechanism for preventing, detecting and reporting crimes, so that sanctions on companies and their agents can generally be fair punishment, adequate deterrence, and incentives for companies [3]. Following is a part of legislation development on corporate compliance for deterring the violations.

Table 1: The Acts and Regulations Made by the United States for Corporate Compliance.

Time	Title	Content
1934	The Securities Exchange Act of 1934	Manipulating market practices and making a false or misleading statement in a document filed under the Act lead to the civil liability and even criminal penalties of the directors[4].
1977	The Foreign Corrupt Practices Act (FCPA)	Foreign bribery was deterred in the Act. The government should prove the specific intent of bribery or the corporation should discourage with conscious winking at the payment of bribes [5].
1988	The Insider Trading and Securities Fraud Enforcement Act of 1988	The Act prevented broker-dealers and investment advisors from misusing of non-public information. Failure to adopt such written procedures could subject a company to penalties. It also advocated the establishment of a program to govern voluntary disclosure of contractor misconduct [6].
2002	The Sarbanes-Oxley Act	The supervision made by the government strengthened. It required senior officers to make certifications about the corporate information disclosure and financial reporting. The Act prohibited personal loans to officers and directors and mandated forfeiture of senior officer bonuses and profits from securities sales in the event of an accounting restatement due to misconduct [7].
2018	U.S. Sentencing Commission Guidelines Manual 2018	The compliance measures were evolved as the business and the markets change. Companies must periodically assess the risk of criminal conduct and make changes in their business or culture [8].

2.2 The Regulatory Rules of Corporate Compliance

The world has witnessed that corporate compliance has roughly experienced the development path of “supervision – deregulation – strengthening supervision – exploring new cooperative supervision” models, which always tend to align with the change of business and market. As can be seen from the above table, the government shifted ex post supervision into ex ante incentive measures. Companies take the initiative to report problems and risks issues, and then can negotiate to mitigate punishment, which aim to encourage companies to construct compliance system.

Generally, the supervision or regulation made by the public agencies is mandatory and the supervised or regulated parties has to obey the rules, or they would be punished for violation. The traditional regulation uses the prohibitions to deter violations and criminals. However, the introduce of capture theory in 1960s by G.J.Stigler argued that the supervisors gradually adapted to the interests of regulators and then ignored the public interests. Finally, public regulations become the guardian of the minority, legally depriving the majority of the interests [9]. It is the shortcoming of traditional regulation theory.

In addition, the theory of incentive compatibility [10] in economics believes that under the condition of information asymmetry, the goals of the two parties (agent and principal) are inconsistent, and the agents often do harm to the interests of the principal. Only by providing the agent with sufficient incentives, the problem of adverse selection and moral hazard in principal-agent relation can be avoided. The incentive regulation is produced from the practice of corporate compliance.

3. The Analysis of Incentive Regulation in Corporate Compliance

As the representative of public power, the traditional regulation focuses on deterrence and ex post supervision. Due to the nature and type of the companies and the inherent characteristics of the corporate governance, the goals of traditional regulation are inconsistent with that of companies, which ultimately leads to the failure of the corporate compliance. The incentive regulation helps to achieve the consistency of companies and the regulator, and the compliance becomes companies’ self-tending choice.

3.1 The Incompatibility of Traditional Regulation in Corporate Compliance

The practice of companies is various and depends on the specific situation. For achieving the goal of corporate compliance, instead of suppressing the nature of companies, the regulation should be changed to adapt to the development of companies and to help them construct compliance system. The prohibitions are the representative of traditional regulation for compliance, which are incompatible with corporate governance.

3.1.1 The Variety Types of Companies VS. The Unity of Regulatory Rules

As mentioned above, the scope of corporate compliance is enough wide, involving the field of criminal law, administrative law and many other sectors of law. Although Chinese current company law divides the types of companies into limited liability companies and joint stock limited companies, the size of the company, the scope of the business, and the composition of the corporate personnel are sufficient to affect the effects of corporate compliance.

At present, Chinese corporate compliance system is mainly concentrated in two types of companies, which are the listed companies and the state-owned enterprises. However, small and medium-sized limited liability companies currently occupy the main types of registered companies

in China. Within such small and micro companies, various organizational structures are not very complete, and corporate governance also has certain flaws. In order to achieve the institutionalization of corporate compliance in China, it is impossible to set rules according to a standard company structure. The development characteristics of each company and the areas with high incidence of compliance risks are the content that needs to be considered in compliance standards.

3.1.2 The Profitability of Companies VS. The Public Interest of Regulation

Companies pursue profit from the date of birth. Therefore, the freedom of corporate operation is protected by law. Although Article 5 of Chinese Company Law stipulates that companies must bear social responsibilities when engaging in business activities. In addition, Article 86 of the *Civil Code of the People's Republic of China* also mentions that for-profit legal persons shall bear social responsibilities when engaging in business activities, but it does not explain the specific meaning of corporate social responsibility, neither stipulate the legal consequences of failing to perform social responsibility obligations, which make these provisions ultimately become abstract guiding norms.

Chinese current company law is still set on the premise of the profitability of companies, which to a certain extent is contrary to the ethical concepts advocated by social responsibility. However, the invisible hand theory created by Adam Smith reveals that in the absence of external institutional constraints, disorderly competition will eventually lead to market chaos, and corporate governance still requires the regulation. Regulation is the intervention of the corporate freedom of operation. The incapability of regulation and internal corporate governance should be solved for the balance between external intervention and the corporate freedom of operation.

3.2 The Effects of Incentive Regulation

The incentive regulation is different from traditional regulation. It encourages companies to construct and improve their compliance system by setting rewards. The positive incentive goal is consistent with corporate governance aim and the companies themselves.

3.2.1 The Definition of Incentive Regulation

The incentive regulation is evident in the criminal law of the United States. In the process of handling corporate fraud and bribery cases, U.S. federal prosecutors can urge the companies involved in the case to establish a compliance system within a certain period of time by reaching a deferred prosecution agreement or a non-prosecution agreement. If the prosecutor believes that the company has fulfilled the agreement and established a company compliance system, law enforcement agencies and regulatory agencies will no longer file public prosecutions with the courts, and the case will eventually end with the company involved in the case being exempt from conviction or avoiding criminal penalties [11]. The *Federal Sentencing Guidelines* 2018 formulated by the Federal Sentencing Commission of the United States changed from the mandatory norms to the advisable norms when sentencing for corporate crimes. This positive incentive measure encourages companies to establish and improve compliance systems.

3.2.2 The alignment of Corporate Governance and Corporate Compliance

Limited by the asymmetry of information between companies and regulator, companies are required to disclose information to prevent from achieving profitability through illegal means. The *Securities Law of the People's Republic of China* stipulates the obligation of information disclosure and the consequences of breach of the obligation. Although issuers and listed companies have a clear

understanding of this regulation, they may still commit a crime under the driven of interests. By breaching the obligation of information disclosure, companies can get more profits from investors by the cost of a small number of fines. The nature of the companies' profitability is unbalanced in the face of interest measurement, which reflects the disadvantage of prohibition regulation.

The incentive regulation encourages companies to disclose information and actively build a compliance system, embeds the utilitarian goals of regulators in the company's profit-seeking choices, and guides companies to actively carry out compliance construction. Under this perspective, companies pursue to receive fair punishment and then to construct corporate compliance on their own initiatives. In the meantime, the aim of regulation is also fulfilled.

3.2.3 The Maximum of Corporate Compliance

Corporate compliance cannot leave without corporate governance as well as the external regulation. The company itself develops corporate compliance under the supervision of incentive regulation, which means the corporate governance is also improved for compliance system.

Although China has not established the criminal compliance system, it still admits positive incentives in the cases (2016) Gan 102 Xing Chu No. 605 and (2017) Gan 01 Xing Zhong No. 89. In 2016, Nestlé employees selling and illegally providing citizens' personal information reflected the use of positive incentives for corporate compliance in Chinese judicial practice. In this case, Nestlé's marketing manager instructed several employees to illegally obtain citizen information by contacting with medical personnel in various hospitals and medical institutions. In determining whether Nestlé committed a corporate crime, the company provided evidence such as its internal policy materials and employee code of conduct, proving that Nestlé did not allow employees to collect consumer personal information in an illegal manner, and that the company has required all employees to receive training and to sign the letter of commitment. The court of first instance held that the violation of Nestlé employees was not a manifestation of the company's will, and therefore determined that the case was not a unit crime. The court of second instance rejected the company's employees' appeal and upheld the original verdict. In fact, Nestlé exempts itself from criminal liability by proving that it has established a compliance system, which reflects the positive incentives for companies as well as the improved internal governance by the compliance system.

4. The Problems of Incentive Regulation of Corporate Compliance

The establishment of a compliance system can reduce or even exempt companies from penalties. But how to judge whether the compliance system has been established becomes a problem. The non-prosecution agreement and the deferred prosecution agreement reached between the US federal prosecutors and companies involved put forward specific requirements for the corporate compliance plan, such as clarifying the content of compliance, prohibiting any illegal activities, formulating specific internal control mechanisms, curbing illegal behaviors in a timely manner, conducting employee training to implement compliance and setting up regular compliance reporting systems [12].

After all, the compliance paper documents cannot reflect the full picture of the corporate compliance. Facing the gap between the regulatory information and the corporate internal governance information, the regular reporting system is particularly important. It is believed that the monitoring and evaluation of corporate compliance should be conducted by external professional forces [13]. Specifically, an autonomous organization jointly established by the government and companies can participate in the dynamic supervision of corporate compliance. The evaluation criteria should also be considered in combination with areas of high incidence of compliance loopholes and the companies' operating characteristics.

5. Conclusion

It can be seen that traditional restriction and control cannot meet the corporate diversified requirements for compliance. Companies initiative needs to be motivated for achieving compliance, and the compliance plan should be embedded in the companies' pursuing through incentives and guidance. At the same time, in the process of regular report, the judgment of compliance should be made in a dynamic environment in order to maximize the corporate compliance goals.

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