E-ALERT | Anti-Corruption

October 18, 2011

WATTS WATER PAYS $3.7 MILLION TO SETTLE CHINA-RELATED FCPA ALLEGATIONS

Charges Allege Payments Made to Employees of State-Owned Design Institutes

On October 13, 2011, the US Securities and Exchange Commission ("SEC") issued an administrative cease and desist order asserting violations of the Foreign Corrupt Practices Act ("FCPA") to Watts Water Technologies, Inc. ("Watts") and a former employee of one of Watts' Chinese subsidiaries. The SEC alleged that the Watts subsidiary paid employees of Chinese state-owned design institutes to recommend Watts' products and to create design specifications that favored Watts' products. Watts agreed to pay $3.7 million to settle the charges, and the former employee agreed to pay $25,000.

Alleged Conduct

Watts, which is listed on the New York Stock Exchange and designs, manufactures, and sells water valves and related products, conducted business in China through a variety of subsidiaries. One of these wholly owned subsidiaries, Watts Valve (Changsha) Co., Ltd. ("CWV"), manufactured and sold valve products for infrastructure projects in China, most of which are developed and run by state-owned entities ("Project SOEs"). These Project SOEs usually engage state-owned design institutes to assist in the design and implementation of their projects.

CWV was created after Watts' acquisition of Changsha Valve in April 2006. The SEC alleged that after the acquisition, Watts "failed to implement adequate internal controls to address the potential FCPA problems posed by its ownership of CWV -- a subsidiary that sold its products almost exclusively to [Project] SOEs." (US enforcement authorities have deemed employees of SOEs to be "foreign officials" under the FCPA.) The SEC further alleged that although Watts implemented an FCPA policy in October 2006, it failed to "conduct adequate training" for its employees in China until July 2009.

According to the Order, CWV made improper payments to design institute employees in order to (1) influence the design institutes to recommend that Project SOEs purchase CWV's products; and (2) draft design specifications favoring CWV's products.

Specifically, the SEC alleged that CWV sales policy, which was carried over from Changsha Valve, stated that all sales-related expenses, such as travel, meals, entertainment, and payment of "consulting fees" to design institutes, were to be borne by CWV sales employees out of their sales commissions, which amounted to 7 to 7.5% of the contract price. Moreover, the sales policy permitted sales employees to use their commissions to make additional payments to design institutes of up to 3% of the contract amount. The improper payments to the design institutes were improperly recorded on CWV's -- and thus Watts' -- books as "sales commissions."

According to the SEC, the former employee, Leesen Chang, at the time vice president of sales for Watts' management subsidiary in China and interim general manager of CWV, approved many of the payments and "knew or should have known that the payments were improperly recorded on Watts' books and records as "sales commissions." Chang, a US citizen, was thus alleged to be a cause of Watts' FCPA violations, in part because he resisted at least one attempt to have the sales policy in question translated for senior US management's review.

In 2009, following allegations that emerged from FCPA training, Watts retained outside counsel to conduct an internal investigation of payments made by Watts and its subsidiaries to employees of Chinese state-owned enterprises. Watts eliminated commission-based compensation, revised its worldwide anti-corruption policy, and conducted a worldwide anti-corruption audit. Watts sold CWV in January 2010.

Implications

The SEC alleged that Watts violated the books and records and internal control provisions of the FCPA, and that Chang violated an SEC rule against falsifying books and records and was a cause of Watts' FCPA violations. Watts and Chang entered into a settlement with the SEC that ordered Watts and Chang to cease the improper conduct. Watts paid disgorgement of $2,755,815, prejudgment interest of $820,791, and a civil monetary penalty of $200,000. Chang paid a civil monetary penalty of $25,000.

This SEC enforcement action reinforces lessons learned from other FCPA and anti-corruption cases, including the need for:

- actual controls that prevent improper payments rather than paper-only policies;
- timely and adequate anti-corruption training for employees;
- scrutiny, from an anti-corruption perspective, and careful control of contingent payments such as sales commissions;
- regular review of sales policies and incentives for corruption risks; and
- anti-corruption policies that are fully implemented in acquired companies and joint ventures.

The enforcement action represents the fourth FCPA enforcement action related to allegations of improper payments to state-owned design institutes in China.[1]

[1] FCPA enforcement actions against ITT Corp (February 2009), Avery Dennison (July 2009), and Rockwell Automation (May 2011) also involved allegations of improper payments to state-owned design institutes in China.

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