COVINGTON

COVINGTON & BURLING LLP

E-ALERT | Anti-Corruption

March 6, 2013

KEYUAN PETROCHEMICALS AND FORMER SENIOR EXECUTIVE PAY OVER $1 MILLION TO SETTLE CHINA-RELATED FCPA ALLEGATIONS BROUGHT BY THE SEC

On February 28, 2013, Keyuan Petrochemicals, Inc. ("Keyuan") and Li Aichun ("Ms. Li"), Keyuan's former Chief Financial Officer, agreed to pay over $1 million to settle allegations that they violated various provisions of federal securities laws, including the books and records and internal control requirements of the Foreign Corrupt Practices Act ("FCPA"), in connection with conduct in China. This joint settlement appears to be the first FCPA-related enforcement action against a China-based company. According to the complaint filed by the SEC ("the SEC Complaint"), Keyuan operated an off-balance sheet cash account that was used to fund gifts for Chinese government officials, as well as to pay for various items for the company and its senior officers. The SEC Complaint also alleged that Keyuan (and Ms. Li) failed to disclose in its SEC filings certain related party transactions between the company and its CEO and controlling shareholders, entities controlled by or affiliated with Keyuan's CEO or controlling shareholders, and entities controlled by the company's management or their family members.

To settle the allegations, Keyuan and Ms. Li agreed to pay $1 million and $25,000, respectively; they also consented to the entry of a judgment permanently enjoining them from violations of the respective provisions of federal securities law.

Alleged Misconduct

Keyuan is a Nevada corporation based in Ningbo, China that engages in business through Ningbo Keyuan Plastics Co. The company's common stock was traded on the NASDAQ until October 2011 and was delisted in April 2012. Keyuan was formed through a reverse merger in 2010 when Ningbo Keyuan Plastics became a wholly-owned subsidiary of a Nevada shell corporation.

According to the SEC Complaint, Keyuan's former Vice President of Accounting created an off-balance sheet cash account holding approximately $1 million. The account was allegedly used, in part, to fund gifts to Chinese government officials, typically around the Chinese New Year. Recipients of these gifts included officials from the local environmental, port, police, and fire departments; the gifts included common household goods, such as bedding and linens, and "red envelopes," which provide the recipient with a direct cash gift. Keyuan also allegedly used this account to pay for various expenses, such as cash bonuses to senior officers, technical experts providing consulting services, and business and living costs incurred by the CEO. The SEC Complaint explained that the account was partially funded by the sale of promissory notes, scrap metal, and construction materials. The account was also funded by Keyuan employees who submitted false reimbursement claims to withdraw cash from the company that was then channeled into the off-balance sheet account. According to the SEC Complaint, Keyuan's use of this account caused the company's reported balances in its financial statements to be misstated, even once the existence of the account was discovered.

The SEC Complaint also alleged that Keyuan violated other federal securities laws aside from the FCPA. Specifically, according to the SEC Complaint, Keyuan "systematically failed" to disclose its related party transactions involving the company's three founding and controlling shareholders, entities controlled or affiliated with them, and entities controlled by Keyuan's management or their family members. These dealings took the form of product sales, purchases of raw materials, loan guarantees, and short-term borrowings and lendings. Keyuan allegedly failed to disclose these transactions in its public filings, and the SEC Complaint singled out Ms. Li, a Chinese national and a resident of North Carolina, for her role in the company's failure to investigate red flags and disclose these transactions.

According to the SEC Complaint, Keyuan's books and records were inadequate because they failed to reflect either the use and disbursement of cash through the off-balance sheet cash account, as well as the related party transactions. The SEC Complaint also highlighted Keyuan's internal controls, arguing that the company's lack of reasonable procedures allowed the company's officers to maintain and use the off-balance sheet cash account and permitted the related party transactions to go undisclosed.

Consequences

To settle the SEC's claims, Keyuan and Ms. Li entered into a joint settlement agreement, under which:

- Keyuan must pay a $1 million penalty;
- Ms. Li must pay a $25,000 penalty;
- Keyuan and Ms. Li consent to the entry of a judgment permanently enjoining them from violations of the relevant provisions of the Securities Act and the Exchange Act; and
- Ms. Li agrees to be suspended from appearing or practicing as an accountant before the SEC, with the right to apply for reinstatement after two years.

Implications

This joint settlement agreement marks what may be the first FCPA-related enforcement action against a China-based company, and the first against a company listed via a reverse merger. It reinforces lessons learned from other FCPA and anti-corruption cases, including the need for:

- monitoring of gifts and entertainment provided to government officials;
- monitoring to ensure truthfulness of employee expense reports;
- scrutiny to prevent conflicts of interest and related party transactions;
- an adequate system of internal controls to ensure payments are made to legitimate and established third parties;
- careful oversight, monitoring, and control of company employees; and
- accurate recording of transactions and disbursements in books and records, including preventing off-balance accounts.

If you have any questions concerning the material discussed in this client alert, please contact the following China-focused members of our Global Anti-Corruption Practice Group:

Eric Carlson	86.10.5910.0503	ecarlson@cov.com
Shaoyu Chen	86.10.5910.0509	schen@cov.com
Tim Stratford	86.10.5910.0508	tstratford@cov.com
Hui Xu	1.202.662.5625	hxu@cov.com
Mingham Ji	1.202.662.5621	mji@cov.com