COVINGTON

PTC Pays $28 Million to Settle FCPA Allegations Over Payments to Employees of State-Owned Entities in China

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Anti-Corruption

On February 16, 2016, PTC, Inc. ("PTC") agreed to pay $28 million to settle allegations by the Securities and Exchange Commission ("SEC") and Department of Justice ("DOJ") that PTC, through its subsidiaries in China, violated the US Foreign Corrupt Practices Act ("FCPA"). The settlement, announced in separate releases by the DOJ and SEC, resolves allegations that, from at least 2006 through 2011, PTC and PTC China violated the FCPA by providing payments and other benefits to government officials at state-owned entities ("SOEs") in China in an effort to increase obtain and retain lucrative contracts. A former PTC sales executive in China also entered into a deferred prosecution agreement with the SEC, the first time that the SEC has done so in an FCPA case.

A. Alleged Misconduct

PTC is a Massachusetts-based software company that issued and maintains a class of publicly traded securities on NASDAQ. The company operates in China through two wholly owned subsidiaries, Parametric Technology (Shanghai) Software Co. Ltd. and Parametric Technology (Hong Kong) Limited (collectively "PTC China").

The statements of facts in the SEC Cease and Desist Order and the DOJ Non-Prosecution Agreement, alleged a broad range of violations. The SEC and DOJ alleged that from at least 2006 until 2011, PTC China provided approximately $1.5 million in improper payments to government officials employed by PTC China's SOE customers. PTC China primarily routed the payments through third-party "business partners," who helped PTC find prospective contracts, assisted with sales to SOEs, and provided other ancillary services in connection with PTC China's contracts with SOEs. These improper payments included non-business leisure travel to places such as New York, Las Vegas, Los Angeles, and Honolulu, as well as excessive gifts and entertainment.

Although PTC policy forbade paying for customers' travel to PTC's headquarters in Massachusetts for training, Chinese government officials often requested that PTC China pay for travel to the United States. The DOJ and SEC alleged that, in contravention of PTC policy, PTC China agreed to provide such travel -- nominally for training at PTC headquarters in Massachusetts -- but primarily for recreational travel to tourist destinations within the United States for purposes of conducting sightseeing and other leisure activities (*e.g.*, golf, guided tours). The DOJ and SEC further alleged that, PTC China, through its business partners, allegedly paid over $1.1 million to fund at least 10 trips for Chinese government officials employed by SOEs, deriving profits of $11.86 million from contracts obtained from SOEs whose employees participated on PTC-sponsored trips. For example, the DOJ and SEC alleged that:

- In April 2008, two PTC China employees accompanied six employees of a Chinese SOE, including its president, on a trip to the United States. In addition to a one-day stop at PTC headquarters in Massachusetts, the group went on sightseeing visits to New York, Las Vegas, Los Angeles, and Honolulu. The trip cost over $50,000, which was paid for by PTC China's business partner and reimbursed by PTC China. Within a year of the trip, PTC booked several contracts with the state owned entity totaling over $1 million.

- In May 2010, a PTC China employee accompanied two employees of a Chinese SOE on a trip to the United States. In addition to a one-day trip to PTC headquarters in Massachusetts, the group also visited New York, Atlanta, Las Vegas, and Los Angeles. In July 2010, another PTC China employee accompanied seven employees of the same Chinese SOE on a second visit to New York, Washington, Las Vegas, San Diego, and Los Angeles. PTC China's business partner paid for both trips and was reimbursed by PTC China. Subsequently, the state owned entity entered into over $9 million worth of contracts with PTC.

- In September 2010, a PTC China employee accompanied nine employees of three Chinese SOEs on a trip to the United States. In addition to a one-day stop at PTC headquarters in Massachusetts, the two-week long trip included sightseeing stops in New York, Los Angeles, Las Vegas, and Honolulu. The Chinese SOEs collectively entered into more than $3.5 million in contracts with PTC.

The DOJ and SEC allege that the travel budgets for such trips were determined between PTC China, its business partner, and the SOE and then added into the contract price. The DOJ and SEC further allege that, in order to disguise these payments, PTC China either: (i) designated the travel expenses as "completely outsourced deals" ("COD"), a budget line item, to make it appear as though the travel expenses were subcontracting payments to the business partner; or (ii) included the travel expense in the business partner's overall commission, which ranged from 15% to 30% of the contract price. After PTC China discovered the COD line item was being improperly used, travel costs were included in business partner commissions paid by PTC China. The business partner paid for the travel expenses at PTC China's direction and received reimbursement for such payments through commission payments or sham invoices for fictitious subcontracted services.

In addition to non-business travel, between 2009 and 2011, the SEC order alleges that PTC China employees provided over $250,000 in excessive gifts and entertainment directly to employees of Chinese SOEs and improperly recorded them as legitimate business expenses. These gifts included iPods, cell phones, GPS systems, gift cards, wine, and clothing. The value of such gifts exceeded monetary limits established by PTC's corporate governance and internal controls policies.

The DOJ and SEC both emphasized that, despite the routine use of business partners in deals in China and the risk of corruption inherent in paying business partners for "influence services," PTC and PTC China failed to conduct sufficient due diligence on their business partners. PTC and PTC China also failed independently to verify the extent to which its business partners performed subcontracted services for its Chinese SOE clients. Finally, although PTC investigated compliance issues at PTC China in 2006, 2008, and 2010, it failed to detect ongoing and systemic illegal payments to Chinese government officials and failed to undertake effective remedial actions. Accordingly, PTC's compliance program with respect to its operations in China was not sufficiently tailored to the risks inherent in its Chinese business.

As part of its remedial efforts, PTC and PTC China conducted a detailed and comprehensive review of their compliance programs, implemented new customer travel policies and additional controls around expense reimbursement, established a dedicated compliance team, including a Chief Compliance Officer and a new

Compliance Director, in China, expanded its compliance resources in China, hired a new management team in China, including a new China President, terminated the PTC China employees involved in the misconduct, and discontinued its use of the business partners implicated in the misconduct.

B. Consequences

To settle the SEC and DOJ's claims that PTC and PTC China violated the FCPA's anti-bribery, internal controls, and books and records provisions, PTC China agreed to pay a criminal penalty of $14.54 million to the DOJ, and PTC reached a $13.62 million civil settlement with the SEC ($11.86 million in disgorgement and $1.76 million in prejudgment interest). Based the remediation efforts outlined above, the DOJ and SEC determined that installing an independent compliance monitor was unnecessary.

Based on the same core conduct alleged by the DOJ and SEC, Yu Kai Yuan, a former PTC China sales executive, entered into a three-year DPA with the SEC. The DPA alleges that Yuan caused violations of the FCPA's books and records and internal controls provisions. Without admitting or denying the SEC's allegations, Yuan agreed to refrain from violating federal securities laws and to cooperate fully with the SEC during the period of deferred prosecution. Of note, this is the SEC's first DPA with an individual in an FCPA case.

C. Observations

Cooperation Credit. This enforcement action appears to be the first example of DOJ's new policy of providing additional detail on how it determined what cooperation credit to give a company for voluntary disclosure, cooperation, and remediation. The first paragraph of the NPA contains a multi-part list of the "factors considered in deciding what credit [PTC China] should receive." PTC China did not receive full cooperation credit from the DOJ because even though PTC China self-reported in 2011, it failed to disclose certain facts that DOJ concluded were known to PTC at the time of the self-report, and only disclosed in 2014 when DOJ "uncovered salient facts regarding the Companies' responsibility for the improper travel and entertainment expenditures at issue independently and brought them to the Companies' attention." PTC China received a 15% discount off the bottom of the applicable Sentencing Guidelines range as "partial cooperation credit." If PTC had received credit for self-reporting, it likely would have earned a lower culpability score and a larger cooperation credit discount.

First Settlement After Yates Memo. In its first settled FCPA enforcement action after the Yates Memo, the DOJ credited PTC China's cooperation in providing "information about individuals involved in the FCPA misconduct."

Another China-Related Travel Case. PTC joins a significant number of other companies that have settled FCPA enforcement actions involving sponsored travel to China officials: SciClone (2016), BMS (2015), BHP Billiton (2015), Avon (2014), Bruker (2014), Pfizer (2012), Biomet (2012), IBM (2012), Alliance One (2010), Daimler (2010), UTStarcom (2009), Avery Dennison (2009), Control Components (2009), Siemens (2008), and Lucent (2007).

Remediation Measures. DOJ and SEC determined that a compliance monitor was not warranted based in part on the extensive remediation measures undertaken by PTC, including:

- reviewing and enhancing PTC's and PTC China's compliance programs, including with respect to policies, training, due diligence for third-party vendors, certifications, and auditing;

- establishing a dedicated compliance team, including a Chief Compliance Officer and a new Compliance Director in China;
- expanding its other compliance resources in China, including hiring a new Vice President of Finance for Asia and adding additional legal staff in China;
- hiring a new management team in China, including a new China President;
- terminating PTC China employees involved in the misconduct;
- discontinuing its use of the business partners implicated in the above conduct and discontinuing the use of business referral partners generally; and
- implementing new customer travel policies and additional controls around expense reimbursement.

Lessons Learned. This settlement also reinforces lessons learned from other anti-corruption cases, including the need to:

- develop and implement effective internal controls designed to verify expense claims and ensure that reimbursed funds are used for appropriate purposes, including gifts, meals, entertainment, and travel;
- adopt robust controls -- including due diligence -- over the use of third parties in China, which continues to be an area of focus for both US and Chinese regulators;
- timely investigate and remediate reports or findings of improper activity, broadening the scope of an internal investigation as necessary if signs show more systemic misconduct; and
- ensure that a company’s compliance program extends to its foreign subsidiaries and joint ventures, with a focus on robust financial accounting controls, easy access by employees of foreign subsidiaries and joint ventures to company anti-corruption policies, requirements, and trainings, and the provision of on-the-ground compliance personnel for high- risk foreign jurisdictions.

Historical Conduct. The settlement also illustrates how regulators view historical conduct -- in this case dating back nearly a decade -- through the lens of present-day compliance expectations, rather than expectations at the time of the misconduct.

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:

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