

UNITED STATES DISTRICT COURT  
FOR THE DISTRICT OF COLUMBIA

UNITED STATES SECURITIES AND  
EXCHANGE COMMISSION  
100 F Street, N.E.  
Washington, D.C. 20549-5030B

Plaintiff,

vs.

RAE SYSTEMS INC.

Defendant.

Case: 1:10-cv-02093  
Assigned To : Huvelle, Ellen S.  
Assign. Date : 12/10/2010  
Description: General Civil

COMPLAINT

Plaintiff United States Securities and Exchange Commission ("Commission")  
alleges:

SUMMARY

1. From 2004 through 2008, RAE Systems Inc. ("RAE" or the "Company") violated the Foreign Corrupt Practices Act of 1977 (the "FCPA") by paying, through two of its joint venture entities in China, approximately \$400,000 to third party agents and government officials in China to influence acts or decisions by foreign officials to obtain or retain business for RAE. These payments were made primarily by the direct sales force utilized by RAE at its two Chinese joint-venture entities, named RAE-KLH (Beijing) Co., Limited ("RAE-KLH") and RAE Coal Mine Safety Instruments (Fushun) Co., Ltd. ("RAE-Fushun").

2. RAE's illicit payments to government officials and third-party agents generated revenues worth over \$3 million and gross margin of \$1,147,800. The Company had inadequate controls to prevent or detect any of these improper payments, and improperly recorded the payments in its books and records.

3. While the payments were made exclusively in China and were conducted by Chinese employees of RAE-KLH and RAE-Fushun, RAE was aware of significant

indications of ongoing bribery at RAE-KLH. At the time, RAE failed to effectively investigate these indications, or red flags, and to stop the bribery from continuing. RAE's failure to act on these significant red flags allowed, at least in part, bribery to continue at RAE-KLH.

4. RAE violated Section 30A [15 U.S.C. §78dd-1] of the Securities Exchange Act of 1934 ("Exchange Act") by corruptly making, through its joint-venture entities, illicit payments to foreign government officials in order to obtain or retain business. RAE also violated Section 13(b)(2)(B) [15 U.S.C. §78m(b)(2)] of the Exchange Act by failing to have an adequate internal control system in place to detect and prevent the illicit payments, and violated Section 13(b)(2)(A) [15 U.S.C. §78(b)(2)(A)] of the Exchange Act by improperly recording the payments in its books and records.

#### **JURISDICTION AND VENUE**

5. This Court has jurisdiction over this action pursuant to Exchange Act Sections 21(d), 21(e), and 27 [15 U.S.C. §§78u(d), 78u(e), and 78aa].

6. In connection with the conduct described herein, RAE made use of the mails or the means or instrumentalities of interstate commerce.

#### **DEFENDANT**

7. RAE is a Delaware corporation headquartered in San Jose, CA. RAE develops and manufactures rapidly-deployable, multi-sensor chemical and radiation detection monitors and networks for the global market. RAE has significant operations in the People's Republic of China ("China"), which are organized under RAE Asia, headquartered in Hong Kong. RAE's common stock is registered with the Commission pursuant to Section 12(b) of the Exchange Act and is listed on the NYSE Alternext US Exchange.

## OTHER ENTITIES

8. RAE-KLH is a joint venture headquartered in Beijing, China. In 2004, RAE acquired a 64% stake in KLH, which then became known as RAE-KLH. In June 2006, RAE negotiated the purchase of an additional 32% stake in RAE-KLH, for a total ownership stake of approximately 96%. Today, RAE-KLH remains a joint venture, with its former sole owner, the Beijing Academy of Sciences, owning 4% of the stock.

9. RAE-Fushun is a joint venture based in Fushun, Liaoning Province, China. In December 2006, RAE acquired a 70% interest in Fushun, and became known as RAE-Fushun. The other 30% is owned by the Liaoning Coal Industry Group Co. Ltd.

## FACTS

### **RAE's Due Diligence of KLH Uncovers Existing Bribery Practices**

10. In 2004, RAE began evaluating possible acquisition or business combinations in China and entered into negotiations with KLH. RAE's due diligence uncovered the following facts:

- a. KLH's primary clients were large state-owned enterprises and government departments.
- b. KLH sales personnel historically financed their sales activities and sales-related travel throughout mainland China using cash advances and reimbursements.
- c. KLH sales personnel often obtained cash advances from KLH's Accounting Department and used such cash advances to bribe government officials in order to obtain or retain business.

11. RAE also learned through its due diligence that KLH sales personnel were required to submit a business expense claim form detailing how each cash advance was spent. In addition, in order to write off sales expenses for tax accounting purposes, KLH sales personnel were required to obtain government-issued tax receipts, known as "fapiao" for all sales expenses.

12. KLH sales personnel, however, often failed to list the true items on which they spent their cash advances. In fact, when fapiao were unavailable or insufficient to cover the expenses incurred, KLH sales personnel often submitted substitute fapiao—that is, fapiao that were genuine but that were not issued for the specific expense incurred. As a result, the records of cash advances and reimbursements at RAE-KLH often lacked adequate support for the purported business purpose.

13. Upon receiving submission of the fapiao, KLH's Accounting Department debited the expense into, depending on the nature of the fapiao, items such as travel, entertainment, or meals, and credited accounts receivable. KLH's Accounting Department knew that KLH sales personnel were submitting inaccurate fapiao, but were comfortable with receiving any type of fapiao, as this allowed the Accounting Department to make certain income statement deductions.

#### **RAE Instructs KLH Personnel to Stop Bribery Practices**

14. During a June 2004 board meeting, RAE instructed RAE-KLH personnel that its business practices (i) shall follow the norms of major multi-national companies doing business in China by utilizing finder's fees, commissions, consulting fees, etc.; and (ii) this shall be properly communicated to the organization and put into practice as soon as practical, but no later than October 1, 2004. RAE also communicated orally to RAE-KLH officers that bribery practices must stop.

15. While RAE communicated these instructions to RAE-KLH personnel, RAE did not impose sufficient internal controls or make any changes to the practice of sales personnel obtaining cash advances. RAE did not, for example, change the fact that inaccurate fapiao was often submitted to justify cash advances.

#### **RAE's CFO Visits RAE-KLH and Observes Evidence of Possible Continuing Bribery**

16. In May 2005, RAE's then Vice President and Chief Financial Officer visited RAE's Chinese facilities, including RAE-KLH. RAE's CFO observed that, from

late 2004 through May 2005, RAE-KLH had approximately \$500,000 in cash advances for which it had not yet received any fapiao.

17. Given this observation, RAE's CFO, e-mailed a report sent to RAE headquarters in the United States, writing, "[t]here is the possibility that cash may also be used for grease payments, to supplement sales employees' incomes and as bribes . . ." The CFO explained that the suggestion of some abuse is derived from, among other things, the "aging balance of un-receipted advances . . . ."

#### **RAE Implements FCPA Compliance Training at RAE-KLH**

18. In response to the CFO report, in early June 2005, the Company implemented FCPA compliance training and required each RAE-KLH employee to certify that he or she did not engage in bribery practices.

19. Again, however, the Company did not impose sufficient internal controls or make changes to the practice of sales personnel obtaining cash advances.

#### **Bribery at RAE-KLH Continues Despite Compliance Training**

20. Despite the measures taken above, bribery persisted at RAE-KLH. In particular, because the Company had not implemented any changes or controls to the cash advance system, RAE-KLH sales personnel could, and often did, obtain cash advances to bribe foreign officials in order to obtain or retain business.

21. In 2006, RAE-KLH booked additional sales revenue, as a result of gifts, entertainment, and other payments provided to government officials, resulting in \$153,717 in total gross margin that would not otherwise have accrued to RAE during this period.

22. As was the case prior to RAE's acquisition of KLH, the expenses associated with these cash advances were improperly recorded on the books of RAE-KLH as "business fees" or "travel and entertainment" (T&E) expenses. They appear to have been classified for U.S. GAAP purposes as T&E expenses.

23. In January 2006, RAE-KLH entered into a consultancy agreement with a Chinese third-party agent, purportedly for technical services rendered in connection with a single government-affiliated oil project contract. RAE-KLH paid the third-party agent RMB 688,000 (approximately \$86,195) pursuant to this contract.

24. The third-party agent, however, did not use these funds for technical services. Rather, the third-party agent, on RAE-KLH's behalf, made improper payments to one or more employees of a state-owned enterprise affiliated with the Dagang Oil Field. As a result of these payments, RAE-KLH won an RMB 5,000,000 contract from the Dagang Oil Field, which resulted in gross margin of \$208,914 that would otherwise have not accrued to the Company.

#### **RAE Becomes Aware of Possible Continuing Bribery at RAE-KLH**

25. In August 2006, the recently terminated General Manager at RAE-KLH sent an e-mail message to RAE headquarters in the United States with a new allegation concerning ongoing bribery practices occurring at RAE-KLH. In particular, the former General Manager alleged that RAE-KLH had entered into an RMB 380,000 (approximately \$48,000) money laundering contract for the purpose of masking kickbacks that had been paid to RAE-KLH clients.

26. In particular, the former General Manager emailed, "[w]e used this contract to pay 380,000 RMB and then get back 355,000 RMB; the balance of the 25,000 RMB was used to purchase invoices at the value of 380,000 RMB . . . these invoices were purchased to offset the personal borrowings of more than 6 million RMB on the account of the company. Those personal borrowings of more than 6 million RMB were actually kickbacks paid to our clients." The former General Manager added that, "this problem needed to be solved as soon as possible; otherwise, it would give the company trouble for falsified increase of profits, commercial bribery, and the like."

27. The Company responded to the specific allegation concerning the alleged money-laundering contract. The money provided by RAE-KLH under this contract was

returned to it. RAE, however, failed to perform an Internal Audit or other investigation into the general allegation that bribery was continuing.

28. Moreover, notwithstanding these allegations, the Company again did not impose any internal controls or make significant changes to the practice of sales personnel obtaining cash advances.

**RAE Acquires Fushun and Bribery Continues at RAE-KLH and RAE-Fushun**

29. In December 2006, RAE acquired its 70% interest in Fushun Anyi, and became known as RAE-Fushun. Fushun Anyi's clients, like RAE-KLH's clients, were largely state-owned enterprises or government departments.

30. Like RAE-KLH, RAE-Fushun sales personnel financed their sales activities and sales-related travel throughout mainland China using cash advances and reimbursements. The expenses associated with these cash advances were improperly recorded on the books of RAE-Fushun as "business fees" or "travel and entertainment" (T&E) expenses. They appear to have been classified for U.S. GAAP purposes as T&E expenses.

31. In 2007, bribery occurred at both RAE-KLH and RAE-Fushun. First, during 2007, RAE-KLH sales personnel continued to use cash advances to bribe government officials. In one such instance, RAE-KLH sales personnel purchased a notebook computer for the Deputy Director of a state-owned chemical plant.

32. Second, in 2007, RAE-KLH entered into an RMB 2,000,000 contract with the same third-party agent it used in connection with its contract relating to the Dagang Oil Field. The third-party agent agreed to, among other things, (i) provide RAE-KLH with market research and consultation services related to the business development of RAE-KLH in mainland China and (ii) maintain and develop sound relationships with authoritative government agencies in mainland China.

33. Some of the money paid for the third party agent's alleged consulting services was improperly used, directly or indirectly, to help RAE-KLH obtain or retain business from customers, including large state-owned enterprises or government departments.

34. Ultimately, the third-party agent's efforts in 2007 resulted in RAE-KLH obtaining two contracts with government clients. RAE-KLH booked approximately \$640,000 in gross margin that would not have otherwise accrued to RAE-KLH without the third-party agent's efforts.

35. RAE-Fushun personnel also engaged in continued bribery practices in 2007. For example, RAE-Fushun personnel provided a variety of luxury items to government officials to obtain or retain business, such as jade, fur coats, kitchen appliances, suits, and high-priced liquor.

36. During 2007 and a portion of 2008, RAE-Fushun, as a result of gifts, entertainment, and other payments provided to government officials, booked additional sales revenue resulting in \$142,048 in total gross margin that would not otherwise have accrued to RAE during this period.

## **CLAIMS FOR RELIEF**

### **FIRST CLAIM**

#### **Violations of Section 30A of the Exchange Act**

37. Paragraphs 1 through 36 are re-alleged and incorporated by reference.

38. As described above, RAE made use of the mails or any means of interstate commerce corruptly in furtherance of an offer, payment, promise to pay, or authorization of the payment of any money, or offer, gift, promise to give, or authorization of the giving of anything of value to foreign officials for the purposes of influencing their acts or decisions in their official capacity, inducing them to do or omit to do actions in violation of their official duties, securing an improper advantage, or inducing such foreign officials to use



their influence with a foreign government or an instrumentality thereof to assist RAE in obtaining or retaining business.

39. By reason of the foregoing, RAE violated, and unless enjoined will continue to violate, Section 30A of the Exchange Act [15 U.S.C. §78dd-1].

### **SECOND CLAIM**

#### **Violations of Section 13(b)(2)(A) of the Exchange Act**

40. Paragraphs 1 through 36 are re-alleged and incorporated by reference.

41. As described above, RAE through its officers, agents, and certain of its foreign joint ventures, failed to make and keep books, records, and accounts, which, in reasonable detail, accurately and fairly reflected its transactions and dispositions of its assets.

42. By reason of the foregoing, RAE violated Section 13(b)(2)(A) of the Exchange Act [15 U.S.C. §78m(b)(2)(A)].

### **THIRD CLAIM**

#### **Violations of Section 13(b)(2)(B) of the Exchange Act**

43. Paragraphs 1 through 36 are re-alleged and incorporated by reference.

44. As described above, RAE and certain of its foreign joint ventures failed to devise and maintain a system of internal accounting controls sufficient to provide reasonable assurances that: (i) payments were made in accordance with management's general or specific authorization; and (ii) payments were recorded as necessary to permit preparation of financial statements in conformity with generally accepted accounting principles or any other criteria applicable to such statements, and to maintain accountability for its assets.

45. By reason of the foregoing, RAE violated Section 13(b)(2)(B) of the Exchange Act [15 U.S.C. §78m(b)(2)(B)].

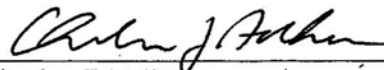
## PRAYER FOR RELIEF

WHEREFORE, the Commission respectfully requests that this Court enter a judgment:

- A. Permanently enjoining RAE from violating Sections 30A, 13(b)(2)(A), and 13(b)(2)(B) of the Exchange Act [15 U.S.C. §78dd-1; §78m(b)(2)(A) and §78m(b)(2)(A)(B)];
- B. Ordering RAE to disgorge ill-gotten gains, with prejudgment interest, wrongfully obtained as a result of its illegal conduct;
- C. Ordering RAE to comply with certain undertakings concerning its Foreign Corrupt Practices Act compliance program; and
- D. Granting such further relief as this Court may deem just and appropriate.

Dated: *December 10, 2010*

Respectfully submitted,



Charles J. Felker  
Cheryl Scarboro  
Ricky Sachar  
Securities and Exchange Commission  
100 F Street, N.E.  
Washington, D.C. 20549-5030B  
Telephone: (202) 551-4960 (Felker)  
Facsimile: (202) 772-9235  
felker@sec.gov

Attorneys for Plaintiff