

Government Announces First Criminal and Civil Cases Focused on Options Timing

by Thomas C. Newkirk

On July 20, the United States Attorney for the Northern District of California filed criminal charges of securities fraud against Gregory L. Reyes, former CEO of Brocade Communications Systems, Inc., and Stephanie Jensen, Brocade's former Vice President of Human Resources. In addition, the SEC filed civil charges against Reyes and Jensen, as well as against Antonio Canova, Brocade's former Chief Financial Officer and Vice President of Finance. Along with securities fraud, the civil charges included making false statements to auditors, falsifying Brocade's books and records, aiding and abetting the company's accounting and internal controls violations, and filing false certifications with the SEC (a charge limited to Reyes and Canova).

The heart of the charges is that Reyes allegedly directed a scheme to backdate options and falsify the company's books and records to understate expenses and overstate income significantly. While today all options have to be expensed, under the accounting rules at the time in question, options issued at the market price at the time of the grant did not have to be expensed. Options issued at below the market price at the time of the option grant did have to be expensed. According to the charges, by pretending that options had been issued at the market price at some time in the past when the stock price was lower than it was at the time of the grant, the company improperly evaded the requirement to expense these options. The SEC's complaint further alleges that the defendants benefited from the fraud

by selling Brocade stock when the stock price was inflated by the overstated earnings and by receiving bonuses and stock options.

The charges against Brocade may be the first of many. At a press conference yesterday, Linda Thomsen, the SEC's Director of Enforcement, said that the SEC has more than 80 option timing investigations underway. The United States Attorney for the Northern District of California said that his office also had a substantial number of cases under criminal investigation beyond the investigation of Brocade.

Brocade itself was not charged yesterday. Interestingly, the company issued a press release saying that it had negotiated a settlement with the SEC Staff and had agreed to pay a \$7 million penalty but that the agreement was subject to approval by the Commission itself. Usually, when the Commission is ready to charge individuals and has a settlement in hand with the company, the Commission will announce both at the same time. While there are many possibilities, one possible explanation for the Commission's failure to do so here might be that the Commission does not share the SEC Staff's eagerness to impose harsh penalties on companies themselves, such as the \$7 million penalty the SEC Staff negotiated with Brocade.

Given the possibility that the Commission is reluctant to impose penalties on public companies in option timing cases, it is all the more important not to give the SEC Staff ammunition to argue for a company penalty in these cases. This means full compliance with the standards for cooperation that the SEC

promulgated in the "Seaboard Order" in 2001 (formally known as *Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934 and Commission Statement on the Relationship of Cooperation to Agency Enforcement Decisions*, <http://www.sec.gov/litigation/investreport/34-44969.htm>). The core elements are self-policing, conducting an independent internal investigation of possible violations, self-reporting and cooperation with the SEC. Failure to comply almost always results in tougher remedies. Compliance with the Seaboard requirements can sometimes temper the remedies imposed by the Commission. Compliance may make a critical difference in the outcome for companies involved in the option timing investigations.

The SEC Complaint against Reyes et al. can be found here:
<http://www.sec.gov/litigation/complaints/2006/comp19768.pdf>

The Joint DOJ-SEC Press Release can be found here:
<http://www.sec.gov/news/press/2006/2006-121.htm>

The SEC Litigation Release can be found here:
<http://www.sec.gov/litigation/litreleases/2006/lr19768.htm>

The Brocade Press Release can be found here:
<http://phx.corporate-ir.net/phoenix.zhtml?c=90440&p=irol-newsArticle&ID=884878&highlight=>

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