

1 MARC J. FAGEL (Cal Bar No. 154425)
2 PATRICK MURPHY (Admitted in N.Y.)
3 ROBERT S. LEACH (Cal Bar No. 196191)
4 SUSAN FLEISCHMANN (Cal Bar No. 207194)

5 Attorneys for Plaintiff
6 SECURITIES AND EXCHANGE COMMISSION
7 44 Montgomery Street, Suite 2600
8 San Francisco, California 94104
9 Telephone: (415) 705-2500
10 Facsimile: (415) 705-2501

11 UNITED STATES DISTRICT COURT
12 NORTHERN DISTRICT OF CALIFORNIA
13 SAN FRANCISCO DIVISION

14 SECURITIES AND EXCHANGE COMMISSION, 15 Plaintiff, 16 vs. 17 BROCADE COMMUNICATIONS SYSTEMS, 18 INC., 19 Defendant.	Civil Action No. COMPLAINT
--	-----------------------------------

20 Plaintiff Securities and Exchange Commission (the "Commission") alleges:

21 **SUMMARY OF THE ACTION**

22 1. From at least 2000 through 2004, certain former officers of Brocade Communications
23 Systems, Inc. ("Brocade" or "the Company") – a San Jose-based computer networking company –
24 caused the Company to significantly and fraudulently overstate its publicly reported income. These
25 actions were primarily carried out through the activities of the former CEO, who routinely provided
26 extra remuneration to employees through backdated stock options while falsifying documents in order
27 to avoid recording the required compensation expenses on the Company's financial statements.

28 2. Pursuant to well-settled accounting principles in effect throughout the relevant period,
Brocade informed its shareholders and the investing public that it did not record compensation

1 expenses for stock option grants to employees because those grants were made at the current market
2 price, i.e. "at-the-money." However, in truth, certain individuals at Brocade were regularly granting
3 employee stock options that were "in-the-money," and for which it was required to record an expense
4 in its financial statements. In order to hide the negative impact these expenses would have upon
5 Brocade's reported income, such individuals falsified records to create the appearance that the options
6 had been granted at the market price on an earlier date. By falsifying the dates on which options were
7 purportedly granted, Brocade reported materially understated expenses, overstated income, and
8 falsely represented in certain Commission filings that the Company had incurred no costs for options
9 grants.

10 3. As a result of the acts alleged in this Complaint, Brocade violated the antifraud
11 provisions of the federal securities laws, falsified books and records, and falsely reported its financial
12 results. The Commission seeks an order enjoining Brocade from future violations of the securities
13 laws, requiring it to disgorge ill-gotten gains and pay civil monetary penalties, and providing other
14 appropriate relief.

15 JURISDICTION AND VENUE

16 4. This Court has jurisdiction over this action pursuant to Sections 20(b) and 22(a) of the
17 Securities Act of 1933 ("Securities Act"), 15 U.S.C. §§ 77t(b) and 77v(a), and Sections 21(d), 21(e)
18 and 27 of the Securities Exchange Act of 1934 ("Exchange Act"), 15 U.S.C. §§ 78u(d), 78u(e) and
19 78aa. The defendant, directly or indirectly, made use of the means and instrumentalities of interstate
20 commerce, of the mails, or of the facilities of a national securities exchange in connection with the
21 acts, practices and courses of business alleged in this complaint.

22 5. This district is an appropriate venue for this action under Section 22 of the Securities
23 Act, 15 U.S.C. § 77v, and Section 27 of the Exchange Act, 15 U.S.C. § 78aa. The transactions, acts,
24 practices and courses of business constituting the violations alleged herein occurred within the
25 Northern District of California, and the defendant may be found in this district.

26 INTRADISTRICT ASSIGNMENT

27
28

1 loss) reported to the shareholders of a public company. The accounting rules also specified that a
2 company must recognize compensation expense if it granted options to a non-employee.

3 11. As a public company, Brocade filed with the Commission annual reports that included
4 audited financial statements, certified by the Company's outside auditors. Brocade's public filings
5 affirmatively stated that the Company accounted for its stock options granted to employees in
6 accordance with generally accepted accounting principles, also known as GAAP, which are the
7 accounting conventions, standards, and rules required for preparing financial statements. GAAP
8 required an expense to be recorded for stock options granted at prices below the market value for the
9 stock on the date of the grant. Brocade made the statements about accounting for stock options in
10 accordance with GAAP in the notes to its audited financial statements, included in its annual reports
11 to shareholders, filed with the Commission on Form 10-K, for its fiscal years 2000, 2001, 2002 and
12 2003. Brocade's annual reports on Form 10-K for its fiscal years 2000, 2001, and 2002 represented
13 that, with the exception of certain pre-IPO options granted in 1999, "[n]o deferred stock
14 compensation related to any other periods had been recorded" Also, Brocade's annual report filed on
15 Form 10-K for fiscal year 2003 represented that, following this rule, the Company did not record any
16 expense for stock options because the strike price for the options granted always equaled the trading
17 price on the date of grants.

18 12. The same claim, that Brocade accounted for its stock options granted to employees in
19 accordance with GAAP, and that no compensation expense was recorded, was set forth in the notes to
20 the unaudited financial statements included with each of its quarterly reports filed on Form 10-Q for
21 the quarters ended April 26, 2003, July 26, 2003, January 24, 2004, May 1, 2004, and July 31, 2004.
22 The representations to Brocade's shareholders in its annual and quarterly filings about the Company's
23 stock option program were untrue.

24 **The Scheme to Backdate Option Grants**

25 13. After Brocade became a public company, Brocade had in place stock option plans,
26 including a plan under which the CEO was given the authority to grant stock options to employees
27 (other than senior officers and directors), as the sole member of a "Compensation Committee" that
28 acted as the "Administrator" of the plan.

1 14. During the period beginning no later than 2000 through 2004, the CEO used the
2 authority delegated to him to choose when to grant options to non-officer employees, as well as how
3 many options to grant. To carry out the options grant scheme, the CEO directed employees in the
4 human resources department to prepare documentation of the options grants to employees for his
5 signature. In particular, the CEO was provided with a list (by name of employee, number of options,
6 hire date for new hires, and other information) of options granted at a purported "Compensation
7 Committee Meeting" occurring on a given date. The CEO was also simultaneously provided with
8 Brocade's stock price history over a period of up to three months, highlighting the lowest closing
9 price during the past period. The CEO signed the documentation for each such grant, attesting that
10 he, as the sole member of the Compensation Committee had granted the options to the specified
11 persons on that date. The documentation purported to specify the date on which the Compensation
12 Committee meeting occurred; in reality the date was selected after the fact because it represented the
13 date with the lowest (or nearly the lowest) closing stock price in the period.

14 15. The minutes of the purported Compensation Committee meeting that documented the
15 options grants were provided to other persons at Brocade who were responsible for recording the
16 grants in Brocade's books and records and preparing the Company's financial statements. Because
17 the documentation falsely represented that the options were granted on an earlier date and that the
18 exercise price for the grants was the earlier market price, the Company did not record an expense
19 related to the grants in its financial statements.

20 16. On at least nine occasions between January 2, 2001 and July 2, 2002, the Company
21 provided employees with "in-the-money" options while evading the requirement that it incur a
22 compensation expense related to those grants. These grants (granting options to purchase over 43
23 million shares) were purported to have occurred on January 2, 2001, April 17, 2001, July 23, 2001,
24 October 1, 2001, October 30, 2001, November 28, 2001, January 22, 2002, February 28, 2002, and
25 July 2, 2002. However, these grant dates were false and the options were actually granted at a later
26 time and then backdated to reflect the earlier date.

27 17. During the 10 consecutive fiscal quarters beginning with Brocade's third quarter
28 ended July 31, 2000, through the fourth quarter ended October 26, 2002, Brocade granted stock

1 options to employees at the quarterly low stock price in 8 of the 10 quarters, and with exercise prices
2 near the quarterly low in the other two quarters, further evidencing that options were being backdated.

3 18. The scheme to backdate stock options continued during 2003 and 2004. On at least
4 six occasions between August 15, 2003 and October 20, 2004, Brocade backdated options grants to
5 provide employees with "in-the-money" options while evading the requirement that Brocade incur a
6 compensation expense related to those grants. These backdated grants (granting options to purchase
7 over 9 million shares of stock) were purported to have occurred on August 15, 2003, October 20,
8 2003, January 22, 2004, February 26, 2004, March 22, 2004, and June 21, 2004.

9 19. During Brocade's five consecutive fiscal quarters beginning with the quarter ended
10 October 26, 2003, through the quarter ended October 30, 2004, Brocade made 32 option grants. Of
11 those grants, 19 grants to over 1,000 employees (granting options to purchase a total of approximately
12 16 million shares) were priced at the weekly low closing price for Brocade's stock, and an additional
13 three grants were priced within just \$0.03 of the weekly low.

14 **Brocade Falsely Reported its Financial Results**

15 20. The options backdating scheme caused Brocade to materially misstate its financial
16 results during the period beginning no later than 2000 through 2004. During this period, relying upon
17 the falsified Compensation Committee Meeting minutes supplied to them, persons working in
18 Brocade's finance department recorded the fraudulent information into Brocade's books and records
19 immediately upon receiving the Compensation Committee Meeting minutes. From those fraudulent
20 books and records, the persons in the finance department incorporated the grants into Brocade's
21 financial statements; because the documents did not indicate that any in-the-money options had been
22 granted, Brocade failed to record any compensation expense related to the backdated options grants.

23 21. Brocade also provided the same documentation about grant dates and employee hiring
24 to the Company's external auditors in connection with their annual audits of Brocade's financial
25 statements. Relying on the false documentation supplied to them, Brocade's auditors concurred with
26 the Company's assessment that no compensation expense needed to be recorded for the options
27 granted to employees.

28

1 27. By engaging in the conduct described above, Brocade, directly or indirectly, in the
2 offer or sale of securities, by the use of the means or instruments of transportation or communication
3 in interstate commerce or by use of the mails:

- 4 (a) with scienter, employed devices, schemes or artifices to defraud;
5 (b) obtained money or property by means of untrue statements of a material fact or
6 omissions to state a material fact necessary in order to make the statements
7 made, in the light of the circumstances under which they were made, not
8 misleading; and
9 (c) engaged in transactions, practices, or courses of business which operated or
10 would operate as a fraud or deceit upon purchasers of securities.

11 28. By reason of the foregoing, Brocade has violated, and unless restrained and enjoined
12 will continue to violate, Section 17(a) of the Securities Act, 15 U.S.C. § 77q(a).

13 **SECOND CLAIM FOR RELIEF**

14 *Violations of Section 10(b) of the Exchange Act and Rule 10b-5 Thereunder*

15 29. The Commission realleges and incorporates by reference Paragraphs 1 through 25,
16 above.

17 30. By engaging in the conduct described above, Brocade, with scienter, directly or
18 indirectly, in connection with the purchase or sale of securities, by use of means or instrumentalities
19 of interstate commerce or of the mails, or of facilities of a national securities exchange:

- 20 (a) employed devices, schemes, or artifices to defraud;
21 (b) made untrue statements of a material fact or omitted to state a material fact
22 necessary in order to make the statements made, in the light of the
23 circumstances under which they were made, not misleading; and
24 (c) engaged in acts, practices, or courses of business which operated or would
25 operate as a fraud or deceit upon other persons, including purchasers and
26 sellers of securities.

