

1 MARC J. FAGEL (State Bar No. 154425)
2 JUDITH L. ANDERSON (State Bar No. 124281)
3 ELENA RO (State Bar No. 197308)

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

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RICHARD W. WIEMING
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10 UNITED STATES DISTRICT COURT
11 NORTHERN DISTRICT OF CALIFORNIA
12 SAN JOSE DIVISION

JW

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13 SECURITIES AND EXCHANGE COMMISSION,

Case No. _____

14 Plaintiff,

COMPLAINT

15 v.

16 KENNETH L. SCHROEDER,

17 Defendant.

18
19 Plaintiff Securities and Exchange Commission (the "Commission") alleges:

20 SUMMARY OF THE ACTION

21 1. From mid-1999 to mid-2002, and once again in 2005, defendant Kenneth L.
22 Schroeder, the former Chief Executive Officer of KLA-Tencor Corporation ("KLA" or "the
23 Company"), a San Jose semiconductor company, engaged in a scheme to illegally backdate stock
24 options granted to KLA executives and employees. Schroeder used dates and prices for stock option
25 grants chosen with hindsight and concealed this practice, causing KLA to hide millions of dollars in
26 expenses from investors and to significantly overstate the Company's income. Schroeder continued
27 to engage in this practice even after being specifically instructed by Company counsel that
28 retroactively selecting grant dates without adequate disclosure was improper.

1 securities exchange in connection with the acts, practices and courses of business alleged in this
2 complaint.

3 7. Venue is proper in this District pursuant to Section 22 of the Securities Act [15 U.S.C.
4 § 77v], and Section 27 of the Exchange Act [15 U.S.C. § 78aa]. Schroeder resides in the Northern
5 District of California, and acts or transactions constituting violations occurred in this district.

6 INTRADISTRICT ASSIGNMENT

7 8. Assignment to the San Jose Division is appropriate pursuant to Civil Local Rules 3-
8 2(c) and 3-2(d) because acts and omissions giving rise to the Commission's claims occurred, among
9 other places in this district, in Santa Clara County.

10 DEFENDANT

11 9. Kenneth L. Schroeder, age 61, resides in Los Altos Hills, California. Schroeder served
12 as KLA's President and Chief Operating Officer after the Company's merger on April 30, 1997 until
13 June 30, 1999, and then as KLA's Chief Executive Officer until January 1, 2006. Schroeder also
14 served on KLA's Board of Directors and its Stock Option Committee from 1997 through 2005.

15 RELEVANT ENTITY

16 10. KLA is a San Jose, California corporation that designs, manufactures and markets
17 systems for the semiconductor industry. At all relevant times, KLA's common stock was registered
18 with the Commission pursuant to Section 12(g) of the Exchange Act and traded on the NASDAQ
19 National Market under the symbol "KLAC." At all times relevant to this action, KLA used a fiscal
20 year ending on June 30.

21 FACTUAL ALLEGATIONS

22 **A. KLA's Stock Option Disclosures**

23 11. During the time period KLA backdated options grants, the Company regularly used
24 employee stock options as a form of compensation to recruit, retain, and incentivize key employees.
25 Each option gave the grantee the right to buy KLA common stock from the Company at a set price,
26 called the "exercise" or "strike" price, on a future date after the option vested. The option was "in-
27 the-money" when granted if the trading price of KLA's common stock exceeded the option's exercise
28

1 price. The option was “at-the-money” when granted if the trading price of KLA’s common stock and
2 the exercise price were the same.

3 12. From at least July 1997 and at all relevant times thereafter, KLA’s primary stock
4 option plan specifically prohibited the grant of in-the-money options. The plan required that the
5 Board of Directors set the exercise price of the Company’s stock options, and that the price could not
6 be less than fair market value on the date of grant, *i.e.*, the closing trading price of KLA common
7 stock on the date when the key terms of the option grant were known.

8 13. KLA also publicly represented, in audited financial statements and other filings with
9 the Commission throughout the relevant period, that its option grants were made at fair market value.
10 In other words, KLA purported to issue options at-the-money, not in-the-money.

11 14. KLA’s public filings affirmatively stated that the Company accounted for its employee
12 stock option plans in accordance with provisions of the Accounting Principles Board’s Opinion No.
13 25, “Accounting for Stock Issued to Employees” (“APB 25”). Under APB 25 and the accounting
14 rules in effect in 1997, through 2005, employers were required to record an expense on their financial
15 statements for the in-the-money portion of any options grant. According to APB 25, that difference
16 must be recorded as compensation expense to be recognized over the vesting period of the option.
17 Consequently, granting in-the-money options to employees could have a significant impact on the
18 expenses and income (or loss) reported to the shareholders of a public company. APB 25 allowed
19 companies, where the key terms of an option grant were known, to grant employee stock options
20 without recording any compensation expense so long as the option exercise price was not below the
21 stock’s market price on the date of the grant.

22 15. KLA made the statements about its accounting for stock options in accordance with
23 APB 25 in the notes to its audited financial statements, including in its annual reports to shareholders,
24 filed with the Commission on Form 10-K, for its fiscal years 1998 through 2005. Also, KLA’s
25 annual reports for fiscal years 2000 through 2004 stated that under the Company’s stock option plans,
26 options were granted at prices not less than the fair market value of the Company’s common stock on
27 the grant date, and in fiscal year 2005, were generally granted at prices not less than the fair market
28

1 value of the Company's common stock on the grant date. Schroeder reviewed and signed each Form
2 10-K that made these false representations for fiscal years 1998 through 2005.

3 16. Schroeder further certified the Forms 10-K for fiscal years 2002, 2003, 2004 and 2005.

4 17. KLA also filed proxy statements that were sent to shareholders and contained false
5 disclosures for fiscal years 1998 through 2002. In these proxy statements, the discussion on executive
6 compensation falsely stated that stock options were granted at market price on the date of grant. In
7 addition, KLA's proxy statement for fiscal year 2001 stated that one of the material terms of certain
8 grants to certain executives was that the exercise price of the options was the fair market value of the
9 Company's Common Stock as of the date of grant. Moreover, KLA's proxy statement for fiscal year
10 2002 stated that certain executives, including Schroeder, received a number of options in the last
11 fiscal year which "were granted at an exercise price equal to the fair market value of the Company's
12 Common Stock on October 2, 2001."

13 18. The representations to KLA's shareholders in its annual and proxy filings about the
14 Company's stock option program were untrue. Schroeder knew or was reckless in not knowing those
15 statements were untrue, because he engineered a scheme to create option grant approvals which
16 falsely represented the date of the grant to make it appear as though KLA was not required to record
17 an expense for its options. In particular, to evade the consequences of granting options to employees
18 in-the-money, Schroeder signed falsely dated options grant approvals to make it appear as though the
19 options had been granted at the market price on an earlier date.

20 **B. Schroeder's Scheme to Backdate Options Grants**

21 19. In 1997, KLA's Board of Directors delegated authority to grant stock options to non-
22 officers to a Stock Option Committee consisting of three directors, and required that at least two
23 members approve each grant. Schroeder served on the Stock Option Committee from its 1997
24 formation through 2005.

25 20. The Board contemplated that the Committee would meet regularly to price options.
26 Rather than the grants being priced at a meeting, however, the Stock Option Committee approved
27 retrospectively-chosen option grant dates and prices and never met regularly during the time period of
28 backdating.

1 21. Beginning in July 1997 and continuing until mid-2002, certain KLA executives used
2 an options backdating practice where the signing of grant approval paperwork was deliberately
3 delayed so that they could look back on KLA's historical closing stock prices and choose one of the
4 historically lowest prices as the purported grant date.

5 22. KLA backdated grants to newly hired and to recently promoted employees ("new hire"
6 grants), as well as to current employees eligible for options at the end of the Company's annual
7 review process (known as "peak performance" or "focal" grants), among others. These backdated
8 grants reflected historically low prices of KLA stock for the weeks prior to the date on which the
9 price was selected.

10 23. In June 1999, a KLA executive instructed the Company's Human Resources ("HR")
11 department about procedures on how to backdate new hire grants: (1) create a list of newly hired
12 employees; (2) wait several weeks; (3) obtain a list of KLA's daily closing stock price for the past
13 several weeks; (4) highlight the three or four lowest prices; and (5) forward the new hire list and the
14 highlighted stock price list to KLA's Stock Option Committee.

15 24. From July 1999 until mid-2002, KLA's HR department followed the procedures
16 outlined for them for the new hire grants. HR department employees prepared the grant approval
17 paperwork and sent it to the Stock Option Committee with a historical chart of KLA's common stock
18 closing prices. KLA's HR department followed these procedures for several months. Thereafter, the
19 Stock Option Committee instructed the HR department to pick one of the lowest prices before
20 forwarding the grant approval paperwork to the Committee.

21 25. Month after month, Schroeder routinely signed backdated new hire option grant
22 approvals without ever ensuring that the grants were accounted for appropriately. Schroeder knew or
23 was reckless in not knowing that these approvals did not communicate the actual correct grant date.
24 Based upon these approvals, Schroeder knew or was reckless in not knowing that KLA would not
25 record expenses for these in-the-money grants. See Appendix A.

26 26. Schroeder knew or was reckless in not knowing that only the Stock Option Committee
27 members had authority to set the date and price of option grants to new hires and the rank-and-file.
28

1 He also understood that by signing the grant approvals, he was authorizing the grants at the purported
2 date and price contained in the approvals.

3 27. Schroeder also approved several peak performance or focal grants using undisclosed
4 backdated grant dates to existing executives and employees. See Appendix A. Each year KLA began
5 its annual employee review process at the beginning of the summer and completed it by the end of
6 August or beginning of September. As with the new hire grants, Schroeder would delay approving
7 the grants, using hindsight to select a purported grant date with a lower stock price. When Schroeder
8 signed the grant approvals, he knew or was reckless in not knowing that they did not communicate
9 the actual correct grant date. Contrary to KLA's representations, Schroeder knew or was reckless in
10 not knowing KLA would not record expenses for these in-the-money grants.

11 28. From mid-1997 to mid-2002, and once again in 2005, KLA approved on 35 occasions
12 backdated grants, which included both new hire and peak performance grants, among others.

13 **C. In a March 2001 Memorandum, Schroeder Receives Legal Advice that He Cannot**
14 **Retroactively Set Stock Prices**

15 29. Schroeder understood the accounting implications of awarding an in-the-money
16 options grant. Soon after he became CEO in July 1999, Schroeder received communications that
17 made him aware of the basic accounting rules for stock options. For example, in September 1999,
18 Schroeder received an email reflecting outside counsel's opinion that certain options granted with an
19 exercise price equal to the fair market value on the date of grant would not result in a compensation
20 expense. During the period of the fraud, Schroeder kept abreast of proposed requirements that all
21 employee stock options (rather than just in-the-money options) be expensed by companies, as well as
22 pronouncements and deliberations by the Financial Accounting Standards Board on stock option
23 accounting.

24 30. Schroeder therefore knew or was reckless in not knowing that KLA would have to
25 record an accounting expense for any options that were granted below fair market value on the date of
26 the grant. He also knew or was reckless in not knowing the requirements for the determination of a
27 grant date, *i.e.*, when the key terms of the option grant were known.
28

1 31. In March 2001, KLA's then-General Counsel communicated to Schroeder that
2 selecting grant prices with hindsight required the Company to take a compensation charge, and that
3 doing so without disclosing the fact could run afoul of the law. On or around March 19, 2001, the
4 GC sent a "Stock Options Pricing" Memorandum to Schroeder. The first sentence in the Summary
5 section stated: "the date at which the price of option grants is determined must be the fair market
6 value of the underlying shares as of the date upon which options are granted."

7 32. The Memorandum further described the accounting rules for stock options and stated:
8 "[a]ny attempt to set a price before such a grant is made raises substantial risks under securities and
9 tax laws [and] accounting rules and gives rise to disclosure obligations." The Memorandum stated
10 that "the Board and its committees are limited in their ability to grant options at a retroactive price
11 without exposing the company to risk of an accounting charge."

12 33. In a March 22, 2001 email back to the General Counsel, Schroeder acknowledged
13 reading the memorandum and responded: "The Compensation Committee has given the Stock
14 Option Committee (Gary, Ken and I) power to set the price of stock options . . . Please don't take
15 away some of my best tools for attracting and retaining people. We need those people to win the
16 battle. Help me, don't just tell me how to follow a strict interpretation of rules. I need a 'war time
17 counselor,' not someone who can recite page and verse."

18 **D. Schroeder Continued Approving Backdated Options Grants Despite Having Read the**
19 **March 2001 Memorandum**

20 34. Although Schroeder understood the accounting implications of awarding in-the-money
21 grants before March 2001, and although he received a further warning in March 2001 that backdating
22 options grants without proper disclosure and accounting ran afoul of securities laws, Schroeder
23 nonetheless continued backdating options grants. After March 2001, Schroeder had the Stock Option
24 Committee approve eight additional new hire grants and two additional peak performance grants, all
25 of which were backdated. See Appendix A.

26 35. For example, KLA awarded several grants to employees purportedly on October 2,
27 2001 at an exercise price of \$29.31, including peak performance grants to officers and non-officers
28 and a new hire/promotion grant. The \$29.31 stock price on October 2, 2001 was the lowest closing

