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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

1 price for KLA's common stock for the second half of 2001. In reality, the grant was not made until
2 on or around October 24, 2001, when KLA's stock was trading at \$40.86.

3 36. Schroeder signed the backdated grant approval, which resulted in Schroeder himself
4 receiving options granted in-the-money at the low price. He approved for himself options to purchase
5 341,100 shares under this grant, which were "in-the-money" by \$5,437,134. Schroeder was by far the
6 largest option recipient under this grant.

7 37. In response to the Sarbanes-Oxley Act of 2002, KLA adopted in mid-2002 new
8 procedures for approving options grants, which included pre-scheduled meetings. As a consequence,
9 backdating became more difficult. Nevertheless, Schroeder backdated an additional grant in 2005.
10 On January 26, 2005, an HR department employee sent an email to Schroeder providing closing stock
11 prices for three previous days in order to price a new hire grant. The email asked Schroeder to
12 confirm using the January 24 price, which was the lowest of the three, and lower than the price on
13 January 26. Schroeder emailed back "OK for the price on 1/24." Schroeder's actions directly
14 conflicted with KLA's then procedures for pre-scheduling Stock Option Committee meetings and
15 pricing options on the actual date of the grant.

16 **E. Schroeder's Backdating Scheme Causes KLA to Falsely Report Financial Results**

17 38. As a public company, KLA filed with the Commission annual reports that included
18 audited financial statements, certified by the Company's outside auditors. KLA's failure to record a
19 compensation expense in connection with the backdated, in-the-money option grants resulted in
20 materially overstated net income on the financial statements in its Forms 10-K as follows: 4% in
21 1998, 46% in 1999, 9.8% in 2000, 156% in 2001, 30% in 2002, 46% in 2003, 15% in 2004 and 4.8%
22 in 2005, for a total of over \$200 million of reported net income cumulatively from 1998 to 2005.
23 KLA also sold securities pursuant to offering documents, including registration statements on Forms
24 S-8 filed throughout the period of fraud, which incorporated the false financial statements.
25 Throughout these periods from 1998 to 2005, Schroeder reviewed KLA's financial statements prior to
26 filing them with the Commission.

27 39. Beginning with the quarterly period ended September 30, 2002 through the quarterly
28 period ended March 31, 2005, Schroeder certified all quarterly financial statements filed for each of

1 KLA's first three quarters. These Forms 10-Q contained materially false and/or misleading financial
2 statements because of KLA's failure to record compensation expenses associated with in-the-money
3 options. Schroeder signed certifications stating, among other things, that he had reviewed the Forms
4 10-Q for these periods and he was not aware of any material misstatements of fact or omissions in
5 those filings.

6 40. In addition, KLA's Forms 8-K filed on April 23, 2003, July 24, 2003, October 22,
7 2003, January 22, 2004, April 21, 2004, July 29, 2004, October 21, 2004, January 20, 2005, April 28,
8 2005, July 28, 2005 and October 27, 2005, each of which announced the Company's financial results
9 for the prior quarter, contained materially false and/or misleading financial information because of
10 KLA's failure to record compensation expenses associated with undisclosed grants of in-the-money
11 stock options. Additionally, KLA's Form 8-K filed on March 21, 2001 announced projected third
12 quarter financial results which were materially false and/or misleading. KLA recorded false and
13 misleading information in its books and records, and the representations to KLA's shareholders in its
14 annual, quarterly and current reports about the Company's stock option program, and its financial
15 results, were untrue.

16 41. KLA's proxy statements (which were sent to its shareholders) for fiscal years 1998
17 through 2002 also made materially false representations about executive compensation. Among other
18 things, in describing executive compensation, the proxy statements each falsely stated that stock
19 options were granted to certain executives at market price on the date of grant. In addition, KLA's
20 proxy statement for fiscal year 2001 stated that one of the material terms of certain grants to certain
21 executives was that the exercise price of the options was the fair market value of the Company's
22 Common Stock as of the date of grant. Moreover, KLA's proxy statement for fiscal year 2002 stated
23 that certain executives, including Schroeder, received a number of options in the last fiscal year which
24 "were granted at an exercise price equal to the fair market value of the Company's Common Stock on
25 October 2, 2001." This statement was false, and further failed to disclose the fact that the options
26 granted to Schroeder were in-the-money by approximately \$5 million.

27 42. KLA provided documentation, which failed to disclose the true grant dates for options
28 to employees and officers, to the Company's external auditors in connection with audits of KLA's

1 financial statements. Relying on the false documentation supplied to them, the auditors concurred
2 with KLA's assessment that no compensation expense should be recorded for the options granted to
3 employees. Schroeder knew or was reckless in not knowing that KLA provided false grant approval
4 information to its auditors.

5 43. In addition, Schroeder signed management representation letters with reference dates
6 of July 27, 1999, September 27, 1999, May 12, 2000, July 24, 2000, September 25, 2000, September
7 27, 2000, November 9, 2000, November 14, 2000, February 14, 2001, May 11, 2001, July 31, 2001,
8 November 14, 2001, December 19, 2001, February 13, 2002, May 13, 2002, July 31, 2002,
9 September 9, 2002, September 20, 2002, September 27, 2002, November 13, 2002, February 13,
10 2003, May 14, 2003, July 23, 2003, September 12, 2003, November 6, 2003, February 5, 2004,
11 March 5, 2004, August 18, 2004, November 2, 2004, December 22, 2004, February 3, 2005, April 29,
12 2005, September 1, 2005 and November 18, 2005 to the auditors during the time period of the fraud
13 falsely asserting that KLA's financial statements were prepared consistently with GAAP.

14 44. Schroeder caused to be signed and filed with the Commission a false Form 4, which
15 was supposed to disclose to the public annual changes in his beneficial ownership of KLA securities.
16 This Form 4, dated December 7, 2001, reported false grant dates for his option grants.

17 45. In May 2006, the Special Committee of KLA's Board of Directors began to investigate
18 the Company's historical options granting practices. As a result of the Special Committee
19 investigation, KLA announced in February 2007 restated financial results to record expenses for
20 options grants to employees. KLA announced the recording of additional pre-tax, non-cash, stock-
21 based compensation expenses of (a) \$348 million for the periods July 1, 1994 to June 30, 2005 under
22 APB Opinion No. 25, and (b) \$28 million for the period from July 1, 2005 through December 31,
23 2006 under SFAS No. 123(R).

24 **F. Schroeder Was Motivated by Personal Gain and Competitive Advantage to Backdate**
25 **Options**

26 46. Schroeder knew that he and other officers of KLA similarly received options
27 backdated as of the same dates as the backdated employee options. He thus was motivated to
28

1 which, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets
2 of the issuer.

3 70. By engaging in the conduct alleged above, Schroeder knowingly provided substantial
4 assistance to KLA's failure to make and keep books, records and accounts which, in reasonable
5 detail, accurately and fairly reflect its transactions and dispositions of its assets.

6 71. By reason of the foregoing, Schroeder has aided and abetted violations by KLA of
7 Section 13(b)(2)(A) of the Exchange Act [15 U.S.C. § 78m(b)(2)(A)]. Unless restrained and
8 enjoined, Schroeder will continue to aid and abet such violations.

9 **EIGHTH CLAIM FOR RELIEF**

10 *(Inadequate Internal Accounting Controls—Aiding and Abetting
Violations of Section 13(b)(2)(B) of the Exchange Act by Schroeder)*

11 72. The Commission realleges and incorporates by this reference Paragraphs 1 through 47,
12 above.

13 73. Based on the conduct alleged above, KLA violated Section 13(b)(2)(B) of the
14 Exchange Act [15 U.S.C. § 78m(b)(2)(B)], which obligates issuers of securities registered pursuant to
15 Section 12 of the Exchange Act [15 U.S.C. § 78l] to devise and maintain a sufficient system of
16 internal accounting controls.

17 74. By engaging in the conduct alleged above, Schroeder knowingly provided substantial
18 assistance to KLA's failure to devise and maintain a sufficient system of internal accounting controls.

19 75. By reason of the foregoing, KLA has aided and abetted violations by KLA of Section
20 13(b)(2)(B) of the Exchange Act [15 U.S.C. § 78m(b)(2)(B)]. Unless restrained and enjoined,
21 Schroeder will continue to aid and abet such violations.

22 **NINTH CLAIM FOR RELIEF**

23 *(Falsifying Books and Records or Circumventing Internal Accounting
Controls—Violation of Section 13(b)(5) of the Exchange Act by Schroeder)*

24 76. The Commission realleges and incorporates by this reference Paragraphs 1 through 47,
25 above.

26 77. By the conduct alleged above, Schroeder violated Section 13(b)(5) of the Exchange
27 Act [15 U.S.C. § 78m(b)(5)] which prohibits anyone from knowingly circumventing a system of
28 internal accounting, or knowingly falsifying certain books, records, and accounts.

APPENDIX A

**Backdated KLA Options Grants From July 1999 To January 2005.
Signed by Kenneth L. Schroeder**

Purported Grant Date	Exercise Price	Compensation Charge Included in Restatement	Type of Grant
7/26/99	\$31.34	\$460,299	New Hire; Promotion; Other
8/20/99	\$31.47	\$1,141,626	New Hire; Promotion; Other
11/30/99	\$42.28	\$922,054	New Hire; Promotion; Other
12/16/99	\$46.44	\$2,457,338	New Hire; Promotion; Other
1/28/00	\$56.31	\$746,641	New Hire; Promotion; Other
2/18/00	\$68.00	\$952,429	New Hire; Promotion; Other
4/14/00	\$57.63	\$6,421,313	New Hire; Promotion; Retention; Other
5/25/00	\$44.13	\$2,929,703	New Hire; Promotion; Retention; Other
7/05/00	\$50.06	\$1,638,875	New Hire; Promotion; Other
8/13/00	\$44.69	\$86,991,587	Peak Performance/Focal; New Hire; Promotion; Retention; Other
10/17/00	\$28.06	\$2,668,599	New Hire; Promotion; Retention; Other
11/10/00	\$26.25	\$16,939,483	Peak Performance/Focal; New Hire; Promotion; Retention; Other
12/22/00	\$31.81	\$5,275,005	New Hire; Promotion; Retention; Other
2/09/01	\$35.88	\$1,585,718	New Hire; Promotion; Retention; Other
4/04/01	\$32.75	\$49,554,744	Peak Performance/Focal; New Hire; Promotion; Retention; Other
5/30/01	\$29.58	\$2,250,190	New Hire; Promotion; Retention; Other
7/10/01	\$46.67	\$6,665,136	New Hire; Promotion; Other
10/02/01	\$29.31	\$135,445,909	Peak Performance/Focal; New Hire; Promotion; Retention; Other
11/20/01	\$45.84	\$624,993	New Hire; Promotion; Retention; Other
1/18/02	\$49.92	\$448,206	New Hire; Promotion; Retention; Other
2/28/02	\$57.91	\$595,752	New Hire; Promotion; Other
1/24/05	\$43.99	\$1,063,382	New Hire; Promotion; Retention; Other