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

14 SECURITIES AND EXCHANGE COMMISSION,

15 Plaintiff,

16 vs.

17 MICHAEL J. BYRD,

18 Defendant.  
19

Civil Action No.

COMPLAINT

WHA  
07 42231

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

22 SUMMARY OF THE ACTION

23 1. From at least 2000 through 2004, Brocade Communications Systems, Inc. ("Brocade" or  
24 "the Company"), a San Jose computer storage networking company, concealed millions of dollars in  
25 expenses from investors and significantly overstated its income by falsifying records relating to  
26 employee stock option grants. The fraudulent scheme was executed by former chief executive officer  
27 Gregory L. Reyes ("Reyes"), who routinely backdated stock option grants to give Brocade employees  
28 and recruits valuable "in-the-money" stock options without disclosing the practice or recognizing the



1 78aa. The defendant, directly or indirectly, has made use of the means and instrumentalities of  
2 interstate commerce, of the mails, or of the facilities of a national securities exchange in connection  
3 with the acts, practices and courses of business alleged in this complaint.

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

8 **INTRADISTRICT ASSIGNMENT**

9 7. Assignment to the San Francisco Division is appropriate pursuant to Civil Local Rule 3-  
10 2(e) because the related litigation, *SEC v. Reyes, et al.* Civil Action No. C-06-4435 CRB (N.D. Cal.),  
11 is pending in that division.

12 **DEFENDANT**

13 8. Michael J. Byrd, 45, of Saratoga, California, was Brocade's CFO and Finance Vice  
14 President from May 1999 until May 7, 2001, when the Company's board of directors promoted him  
15 to COO and president. He retired from Brocade in January 2003. Before joining Brocade, he was  
16 CFO of another public company, Maxim Integrated Products, Inc. From 1982 to 1994, he held  
17 various positions, including partner, at Ernst & Young. He is a licensed CPA in California on  
18 inactive status.

19 **RELEVANT ENTITY**

20 9. Brocade is a Delaware corporation based in San Jose, California, that develops and sells  
21 storage networking products. Since May 1999 when it completed its initial public offering of stock,  
22 Brocade's securities have been traded on the Nasdaq National Market, and the Company has had  
23 common stock registered with the Commission under Section 12(g) of the Exchange Act. At all  
24 times relevant to this action, Brocade used a fiscal year ending on the last Saturday in October. In  
25 May 1999 when the Company went public, Gregory L. Reyes was Brocade's CEO and a member of  
26 its board of directors, and beginning in May 2001, Reyes became chairman of Brocade's board of  
27 directors. Reyes maintained those positions until resigning them in January 2005. Reyes continued  
28 as a director until April 22, 2005, and was described by the Company as an advisor until July 2005.

1  
2 **FACTUAL ALLEGATIONS**

3 **The Backdating Scheme**

4 10. Brocade became a public company in May 1999 and quickly experienced substantial  
5 growth in revenue and in the size of its operations. Between October 1999 and October 2002,  
6 Brocade increased the size of its workforce more than six-fold, hiring over 1,150 employees.

7 11. To recruit and retain key employees, Brocade made liberal use of employee stock  
8 options as a form of compensation. The stock options gave employees the right to buy Brocade's  
9 stock at a set price, called the exercise price or "strike" price. The value of the options to the  
10 employees increased to the extent that the market price of Brocade's stock exceeded the strike price  
11 of the options.

12 12. Under the accounting rules in effect from the time Brocade became a public company in  
13 1999 through 2004, U.S. public companies were permitted to grant stock options to employees  
14 without recording an expense in their financial statements so long as the strike price of the option was  
15 at or above the market's closing price for the stock on the day the options were granted. However, for  
16 any options granted "in-the-money" – that is, with a strike price below the market price when granted  
17 – public companies were required to record a compensation expense in their financial statements.  
18 Consequently, granting in-the-money options to employees could have a significant impact on the  
19 expenses and income (or loss) reported to the shareholders of a public company.

20 13. As a public company, Brocade filed with the Commission annual reports that included  
21 audited financial statements, certified by the Company's outside auditors. Brocade's public filings  
22 affirmatively stated that the Company accounted for its stock options granted to employees in  
23 accordance with generally accepted accounting principles, also known as GAAP, which are the  
24 accounting conventions, standards, and rules required for preparing financial statements. Brocade  
25 further represented that it followed a provision under GAAP requiring an expense to be recorded for  
26 stock options granted at prices below the market value for the stock on the date of the grant.

27 14. Brocade made the statements about accounting for stock options in accordance with  
28 GAAP in the notes to its audited financial statements, included in its annual reports to shareholders

1 filed with the Commission on Form 10-K, including those for its fiscal years 2000, 2001 and 2002.  
2 Brocade's annual reports on Form 10-K for its fiscal years 2000, 2001, and 2002 represented that,  
3 with the exception of certain pre-IPO options granted in 1999, "[n]o deferred stock compensation  
4 related to any other periods had been recorded."

5 15. In contravention of Brocade's disclosed practice, CEO Reyes and others systematically  
6 created false and misleading "minutes" of purported "meetings," or similar documentation, that  
7 represented that options had been granted to employees and executives on particular dates and used  
8 the closing price of Brocade's stock on those dates as the options exercise price, although the options  
9 had actually be granted and the paperwork prepared days, weeks, or months afterward, when the  
10 market price for Brocade's stock was higher. The employees and executives were thereby provided  
11 extra, undisclosed compensation in the form of in-the-money options, while Brocade failed to record  
12 the necessary expense for the extra compensation.

13 16. During Byrd's tenure at Brocade, the backdating scheme resulted in materially misstated  
14 quarterly and annual financial statements and required reports, which Brocade restated in 2005. For  
15 example, after restating its financial results, net income for fiscal years 1999 through 2001 declined  
16 by a total of \$303 million. Brocade's false and misleading periodic reports were also incorporated by  
17 reference into registration statements filed by Brocade with the Commission on Form S-8.

#### 18 **Byrd Learns of Manipulated Options Grants to Executives**

19 17. Byrd joined Brocade as CFO in May 1999 and, until late 1999, assisted Reyes in making  
20 stock option grants to employees. After 1999, Byrd was at times consulted about potential grants, but  
21 was not routinely involved in the preparation or review of options grant lists.

22 18. On October 22, 1999, Reyes emailed Byrd and others stating that Reyes had awarded  
23 options to a vice president on a date several months earlier when Brocade's stock price was trading at  
24 a much lower price, but the grant had "fallen through the cracks." Reyes directed that the individual  
25 be "added retroactively" to a list of grantees to be reviewed with Brocade's board. While others  
26 responded to Reyes' directive, Byrd learned through subsequent emails that the number of options to  
27 be retroactively granted to the employee had not yet been established. Although Byrd understood that  
28 GAAP required that the number of options be determined at the time of the grant in order to avoid a

1 compensation expense, Byrd permitted the after-the-fact determination of the number of options to go  
2 forward, without ensuring that Brocade recorded the necessary expense.

3 19. Ultimately, after Reyes settled on an option grant of 20,000 shares to the employee, Byrd  
4 sought assurance from Reyes that Reyes, in fact, had determined to grant the option several months  
5 earlier as he had claimed. In an October 24, 1999 email, Byrd wrote: "Greg [Reyes] needs to give us  
6 a note," providing written assurance that the grant had actually been made by Reyes on the date  
7 indicated in the grant paperwork. However, Byrd did not take steps to determine whether Reyes had  
8 actually determined on the date assigned to the grant the number of options to be granted to the  
9 employee, nor did he check to see that Reyes had provided a "note" in the vice president's file that  
10 said he had done so. Brocade did not record an expense in its financial statements for this in-the-  
11 money grant.

12 20. In October 1999, in response to an accounting interpretation then being proposed, Byrd  
13 emailed Reyes suggesting that to provide well-timed options grants to individuals before they started  
14 working full time for Brocade, the Company should hire the employees on a part time basis and "pay  
15 them for four hours a week until they start." Byrd understood the proposed accounting interpretation  
16 regarded the definition of an "employee," which was important because the granting of options to  
17 non-employees would require a public company to record an expense. Byrd added that he viewed his  
18 suggestion to Reyes as a "silly solution but it is the only one I can think of."

19 21. Brocade thus instituted a so-called "part-time" program, which became the subject of  
20 abuse and a means for granting options to individuals who were not employees on the date stock  
21 options were purportedly granted to them. Byrd became aware of facts suggesting that Reyes and  
22 others were misusing the part-time program.

23 22. On June 27, 2000, Reyes and Byrd received an email forwarding a June 23, 2000 request  
24 from a Brocade recruiting manager seeking authority to make an offer of employment, including a  
25 proposed option grant, to an individual then interviewing at Brocade for a vice president position.  
26 The email indicated that as of June 23, 2000, the VP candidate had not yet been given an offer and  
27 was employed full-time at another company. Although on June 23, 2000 Brocade's stock closed at  
28 approximately \$156 per share, the manager recommended that the VP recruit be offered options with

1 a strike price of "\$135 or less." The June 27, 2000 email (sent when Brocade's price was trading at  
2 \$160 per share), stated: "Greg [Reyes] and Mike [Byrd] will need to approve offer date (i.e. 6/14  
3 @[\$]138.141 or 6/12 @[\$]134.313)."

4 23. The candidate received an offer letter dated June 12, 2000, two weeks prior to the email  
5 exchange discussing his potential hiring, which indicated he would be granted 125,000 options, and  
6 described a supposed part-time start date of June 12, 2000. The candidate, along with many other  
7 Brocade employees, was ultimately granted options in a grant that was dated June 12, 2000 and which  
8 described the strike price as the supposed "fair market value" of \$134.31, the closing price of  
9 Brocade's stock on June 12, 2000. Brocade did not record an expense for this in-the-money grant,  
10 and Byrd did not notify the Company's auditors that the candidate was neither a part-time nor a full-  
11 time employee on June 12, 2000.

12 24. Again, on August 7, 2000, a Brocade VP emailed Reyes, Byrd and others, informing  
13 them that he had identified an ideal candidate for director of software at Brocade. However, the email  
14 indicated that a lucrative package would be required to lure the candidate away from another  
15 company where he was then employed full-time. The VP sought authority from Reyes to offer  
16 options for "130,000 shares-150,000 shares at [\$]160." On August 7, 2000, Brocade's stock was  
17 trading in the \$199-\$214 range, and the email made clear that the requested strike price of \$160  
18 would create a "current value of \$5.2 [million] at 200 [dollars per share]."

19 25. Reyes responded by emailing Byrd and others, stating: "The great news is that I  
20 approved his stock some time ago when he agreed to become a part time employee. The gain that he  
21 has should be compelling." Notwithstanding the inconsistency of Reyes' purported "approval" of a  
22 grant before the candidate had even been offered or accepted the position, Byrd sent an email to  
23 another person working closely with Reyes in preparing the options grants, merely stating: "Please  
24 make sure that we made [the candidate] a part time employee when his stock option was granted and  
25 all of the documentation is in agreement with this fact." Brocade did not record an expense for this  
26 in-the-money grant.

27 26. In September 2001, after Byrd had become Brocade's COO, Byrd began recruiting  
28 Richard Geruson for a position as Brocade's chief marketing officer. Byrd's efforts were

1 unsuccessful; Geruson turned down the position in November 2001, and it was offered to someone  
2 else. However, in late December 2001, Geruson began interviewing with Byrd for a different  
3 position, as Brocade's vice president of customer care. Sometime in mid-January, Byrd verbally  
4 offered the position to Geruson, who accepted this position on January 23, 2002. On February 13,  
5 2002, Byrd sent an email to all Brocade employees announcing Geruson's arrival and welcoming him  
6 to Brocade.

7 27. Despite the fact that Geruson did not accept employment with Brocade until January  
8 2002, around February 6, 2002, Reyes signed minutes of a purported Committee meeting on October  
9 30, 2001 indicating that Geruson's hire date was October 30, 2001 and that Reyes awarded options to  
10 Geruson (and many others) on October 30, 2001 with a \$24.20 exercise price, which was the closing  
11 price of Brocade's stock on that date. Brocade did not record an expense for this in-the-money grant.

12 28. On February 11, 2002, shortly before Geruson actually started working at Brocade, Byrd  
13 received emails from an employee in Brocade's human resources department stating that Geruson had  
14 requested that his official full-time start date be changed to February 13, 2002. Byrd responded by  
15 stating, "[w]e need to make sure that the record reflects that this is his full time start date vs. his  
16 earlier part-time start date." The employee emailed Byrd back that the "part-time" start date had been  
17 designated October 30, 2001, to which Byrd responded by thanking the employee. As Byrd was  
18 aware, Geruson did not begin work at Brocade – part-time or otherwise – until February 2002. Byrd  
19 also did not reveal this discrepancy to the Company's external auditors.

20 29. On January 31, 2002, Byrd interviewed Daniel Cudgma for a position as a Brocade sales  
21 director. Byrd knew that Reyes would also interview Cudgma for the position. On the morning of  
22 February 1, 2002, Reyes met with Cudgma and, later that day, Reyes sent an email to Byrd and others,  
23 stating "I love Dan [Cudgma]." Reyes suggested that Cudgma be hired and directed that Cudgma be  
24 given "the Q1 option \$2x.xx option price," referring to Brocade's closing stock price on November  
25 28, 2001 (\$28.82), one of the low closing prices in Brocade's first fiscal quarter. On February 1,  
26 2002, Brocade's stock was trading around \$37 per share, and had not traded below \$30 per share  
27 since November 28, 2001.

