UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 56519 / September 25, 2007

ACCOUNTING AND AUDITING ENFORCEMENT
Release No. 2725 / September 25, 2007

ADMINISTRATIVE PROCEEDING
File No. 3-12825

In the Matter of **ELECTRONIC DATA SYSTEMS CORPORATION,** **Respondent.**	**ORDER INSTITUTING CEASE-AND-DESIST PROCEEDINGS, MAKING FINDINGS AND IMPOSING A CEASE-AND-DESIST ORDER PURSUANT TO SECTION 21C OF THE SECURITIES EXCHANGE ACT OF 1934**

I.

The Securities and Exchange Commission ("Commission") deems it appropriate that cease-and-desist proceedings be, and hereby are, instituted pursuant to Section 21C of the Securities Exchange Act of 1934 ("Exchange Act") against Electronic Data Systems Inc. ("Respondent" or "EDS").

II.

In anticipation of the institution of these proceedings, EDS has submitted an Offer of Settlement (the "Offer") which the Commission has determined to accept. Solely for the purposes of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the findings herein, except as to the Commission's jurisdiction over it and the subject matter of these proceedings, which are admitted, Respondent consents to the entry of this Order Instituting Cease-and-Desist Proceedings, Making Findings and Imposing a Cease-and-Desist Order Pursuant to Section 21C of the Exchange Act ("Order"), as set forth below.

III.

On the basis of this Order and Respondent's Offer, the Commission finds that:[1]

A. RESPONDENT

EDS is a Delaware corporation headquartered in Plano, Texas. EDS is in the business of providing information technology services. Its common stock is registered with the Commission pursuant to Section 12(b) of the Exchange Act and trades on the New York Stock Exchange. In 1995, EDS acquired A.T. Kearney, Inc., a management consulting firm with operations in 37 countries ("ATK"). In January 2006, EDS completed the sale of ATK.

B. SUMMARY

This matter concerns reporting and books and records violations by EDS. In the first quarter of 2002, EDS failed to disclose the cost of certain derivatives contracts. In the second quarter of 2002, EDS failed to disclose adequately the cost of those contracts. In the third quarter of 2002, EDS selectively disclosed to certain analysts the cost and early settlement of the outstanding derivatives contracts. In addition, EDS failed to disclose adequately an extraordinary transaction with a major customer that increased its reported cash flow by $200 million in the second quarter of 2002. Moreover, EDS maintained inaccurate books and records by employing certain inaccurate assumptions in accounting models used to estimate revenues and expenses for one of its largest contracts. EDS also maintained inaccurate books and records between 2001 and 2003 as a result of a false invoicing scheme discovered by EDS and reported by EDS to the Commission in early 2004, by which a former employee at a former subsidiary made improper payments to officials of Indian government-owned customers.

C. FACTS

1. *EDS's Derivatives Transactions*

In December 2001, EDS began entering into derivatives contracts with a financial institution to reduce the expected cost of its employee stock option program in the event that EDS's share price increased. These transactions involved EDS buying "capped collar contracts," which obligated EDS to purchase its shares on future dates at predetermined prices, and selling put contracts, which gave the financial institution the option of selling EDS shares to the company on future dates at predetermined prices if EDS's share price fell below certain levels. The transactions included "trigger" provisions linked to EDS's share price. These provisions allowed the financial institution to force immediate settlement of a contract if EDS's share price fell below 50 percent of the exercise price of that contract.

[1] The findings herein are made pursuant to Respondent's Offer of Settlement and are not binding on any other person or entity in this or any other proceeding.

In December 2001, EDS disclosed in a press release that "it may occasionally repurchase common shares in 2002 and 2003 to be held for reissuance under the company's equity based incentive and benefit plans . . . in the open market or in other transactions."

In its Form 10-K for the year ended December 31, 2001, EDS disclosed the extent of its obligations under its stock incentive plans, including the fact that options for 15.1 million shares were presently exercisable. EDS also disclosed the derivatives contracts as follows:

> During 2001, the Company initiated a program to manage the future stock issuance requirements of the stock incentive plans described in Note 10 by utilizing equity investment contracts for EDS common stock. At December 31, 2001, the Company owned equity contracts to purchase 539,000 shares of EDS common stock at a weighted-average price of $70.14. The Company also had put obligations covering 821,000 shares of EDS common stock at a weighted-average price of $70.73. All of these instruments expire in 2002. These contracts permit cash or net share settlement at the Company's option.

a. <u>The First Quarter of 2002</u>

By March 31, 2002, EDS had entered into capped collar and put contracts to buy over four million shares of its stock from the financial institution at an expected cost of over $265 million, an increase of about $170 million from the expected cost at the end of 2001. EDS did not include any mention of these derivatives transactions in its Form 10-Q for the quarter ended March 31, 2002.

b. <u>The Second Quarter of 2002</u>

During the second quarter of 2002, EDS entered into additional derivatives contracts with the financial institution. As of June 30, 2002, EDS had outstanding derivatives contracts to buy over 5.1 million shares of its stock from the financial institution at an expected cost of over $317 million.

EDS made some limited disclosures regarding these derivatives contracts in its Form 10-Q for the quarter ended June 30, 2002. The filing states that EDS "owned equity contracts to purchase" 2.6 million shares of its stock at a weighted average price of $61.58 and "had put obligations covering" 2.5 million shares at a weighted average price of $62.90. EDS intended at all times to physically settle the transactions. When EDS filed this Form 10-Q on July 26, 2002, its share price was about $32. The only disclosure regarding the timing of settlement was the phrase "all of these instruments expire in 2002."

c. <u>Selective Disclosures of the $225 Million Derivatives Settlement</u>

After announcing on September 18, 2002 that its earnings and cash flow would fall far short of prior guidance, EDS's share price fell over 50 percent, causing the trigger provisions in all of EDS's remaining derivatives contracts to go into effect. Although all of the derivatives contracts were required by their terms to be settled by year-end in the ordinary course of business, the financial institution demanded that EDS immediately settle the outstanding transactions. The settlement occurred on September 20, 2002 and cost EDS over $225 million.

EDS personnel disclosed this $225 million payment to securities analysts from one broker-dealer on September 19, 2002 and to analysts from two other broker-dealers on September 23, 2002. EDS disclosed publicly on September 24, 2002 that it had closed out its position in these obligations through the issuance of commercial paper, but did not publicly disclose the $225 million cost of settlement until November 14, 2002 when it filed its Form 10-Q for the quarter ended September 30, 2002.

2. *EDS's Failure to Disclose the Basis for Its Improving Cash Flow*

EDS did not adequately disclose the basis that led it to report a large one-time boost to its free cash flow, a financial metric that was closely followed by EDS analysts.[2]

Between April and mid-June, 2002, EDS and a major customer negotiated a $200 million prepayment by the customer in return for monthly credits against EDS invoices for services totaling approximately $221 million over 24 months. Concurrently, EDS and the customer negotiated a modification and a one-year extension of their computer outsourcing agreement.

In its Form 10-Q for the quarter ended June 30, 2002, EDS included the prepayment as deferred revenue on the statement of cash flows and included the following in the description of "Liquidity and Capital Resources" in its Management Discussion and Analysis:

> Net cash provided by operating activities increased $178 million to $759 million for the six months ended June 30, 2002 compared with $581 million during the corresponding period of the prior year. The increase in cash flow from operating activities was primarily due to increases in earnings, excluding depreciation, amortization and changes in accounting for derivatives, and changes in working capital items. The increase in the usage of cash for total receivables in 2002 as compared to 2001 was primarily due to unbilled revenue attributable to certain large government clients, somewhat offset by a decrease in trade receivables. This increase of receivables was more than offset by an increase in deferred revenue due to an increase in customer prepayments as well as lower payments on current liabilities.

The reference to "an increase in deferred revenue due to an increase in customer prepayments" was insufficient to convey the unusual nature of the $200 million prepayment. Although EDS recorded several much smaller prepayments in the period, the Form 10-Q failed to

[2] Free cash flow is a non-GAAP measure that EDS defines as operating cash flow minus capital expenditures.

disclose that a $200 million prepayment came from a single, existing customer and did not represent additional business from a new customer. The $200 million amount was unprecedented to EDS, and comprised over 90 percent of EDS's free cash flow in the second quarter of 2002, and over one-quarter of its operating cash flow during the first six months of the year. The $200 million prepayment transaction included $21 million in discounts from future sales, as well as a credit rating trigger found in no previous EDS prepayment agreement, that could require EDS to refund the prepayment if EDS's credit rating dropped by five levels. At the time that the Form 10-Q for the second quarter of 2002 was filed, EDS's credit rating was under review for possible downgrade.

3. *The NMCI Contract*

In October 2000, the U.S. Department of Defense awarded EDS a five year $6.9 billion contract to build an intranet for the Navy and the Marine Corps (the "NMCI contract"). Over the term of the NMCI contract, EDS expected to deploy over 360,000 "seats," or computer workstations. The contract required EDS to make a large up-front investment to build a secure and highly-advanced infrastructure capable of supporting the 360,000 seat intranet.

In accounting for the NMCI contract over the course of performance, Generally Accepted Accounting Principles required EDS to prepare reasonably dependable estimates of revenues and expenses over the life of the contract in order to determine whether the NMCI contract was in a loss position. EDS's internal policies and procedures required preparation of quarterly accounting models that conformed to the terms of the NMCI contract and that reflected the most likely outcome of the contract's key assumptions, such as seat deployment levels. In the first and second quarters of 2002, EDS prepared NMCI contract accounting models reflecting that it would deploy 160,000 seats during the five-year contract term.

At the time these models were employed, EDS had an insufficient basis to assume that only 160,000 seats would be deployed over the life of the contract, because that seat level assumption was inconsistent with the higher seat levels contemplated by the NMCI contract and anticipated by EDS.

4. *EDS's Recording of Payments on False Invoices at its A.T. Kearney, Inc. Subsidiary*

Beginning in September 2003, EDS discovered that the head of the ATK branch in India ("ATKI") was diverting cash by causing ATKI to pay false invoices from dummy vendors. Between 2001 and 2003, the employee used some of the cash to pay numerous bribes totaling at least $720,000 to high level employees of two Indian state-owned enterprises, who threatened to cancel their contracts with ATKI after issues arose with those contracts' implementation. These payments took the form of cash transfers, gifts and services and continued until discovered by EDS in September 2003. The Indian state-owned enterprises did not cancel the contracts, and ATKI derived revenues from those contracts. EDS investigated and reported this matter to the Commission in February 2004.

By reason of this false invoicing scheme, EDS incorrectly recorded these amounts in its accounting books and records.

D. LEGAL ANALYSIS

1. *Violations of the Reporting Provisions of the Exchange Act*

Section 13(a) of the Exchange Act and Rule 13a-13 thereunder require issuers with securities registered under Section 12 of the Exchange Act to file quarterly reports with the Commission on Form 10-Q. These reports must be complete and accurate in all material respects. *See, e.g., SEC v. Savoy Indus., Inc.*, 587 F.2d 1149, 1165 (D.C. Cir. 1978*), cert. denied sub nom. Zimmerman v. SEC,* 440 U.S. 913 (1979). No showing of scienter is necessary to establish a violation of Section 13(a). *Savoy Indus., Inc.*, 587 F.2d at 1167.

Exchange Act Rule 12b-20 requires an issuer to include in its periodic reports any "material information . . . necessary to make the required statements, in the light of the circumstances under which they were made[,] not misleading."

Exchange Act Rule 13a-13 requires issuers' quarterly reports to comply with the disclosure requirements of Regulation S-K Item 303. Item 303 requires issuers to include a "Management's Discussion and Analysis of Financial Condition and Results of Operations" (MD&A) section in their periodic public filings. Item 303(b) requires issuers' filings to discuss material changes in the items enumerated in Item 303(a). Among other things, Item 303(a) requires issuers to discuss in the MD&A sections of their public filings their financial condition, changes in their financial condition, any known "commitments, events or uncertainties that will result in or that are reasonably likely to result in the registrant's liquidity increasing or decreasing in a material way" (Item 303(a)(1)) and "any known trends or uncertainties that . . . the registrant reasonably expects will have a material favorable or unfavorable impact on net sales or revenues or income from continuing operations" (Item 303(a)(3)). The instructions to Rule 303(a) specify that "liquidity" for purposes of the rule "refers to the ability of an enterprise to generate adequate amounts of cash to meet the enterprise's needs for cash."

To comply with the Commission's disclosure requirements, an issuer's filings must be understandable to ordinary investors. *See, e.g. Virginia Bankshare, Inc. et al. v. Sandberg*, 501 U.S. 1083, 1097 (1991) ("The point of a proxy statement, after all, should be to inform, not to challenge the reader's critical wits.") While "[c]orporations are not required to address their stockholders as if they were children in kindergarten," *Richard v. Crandall*, 262 F. Supp. 538, 554 (S.D.N.Y. 1967), "it is not sufficient that overtones might have been picked up by the sensitive antennae of investment analysts." *Gerstle v. Gamble-Skohmo, Inc.*, 478 F.2d 1281, 1297 (2nd Cir. 1973).

Exchange Act Rule 13a-13 also requires issuers to file quarterly reports that comply with the Commission's Regulation S-X. This mandates that financial statements be presented in conformity with GAAP. Consensus positions on accounting issues by the Emerging Issues Task Force ("EITF") of the FASB are GAAP. *See In the Matter of Robert D. Potts*, Release No. 34-

39126 (September 24, 1997). Financial statements not prepared in accordance with GAAP are presumed to be "misleading or inaccurate." *See* Regulation S-X, Section 4-01(a).

On March 21, 2002, the EITF issued a revised consensus position that imposes various disclosure requirements on issuers, like EDS, engaged in derivatives transactions indexed to their own stock. *Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company's Own Stock*, EITF Issue No. 00-19 ("EITF 00-19"). EITF 00-19 requires issuers to disclose, *inter alia*, the contracts' current fair values, how changes in the price of the issuer's stock affects the fair values of the contracts, and the maximum number of shares that the company may be required to issue in a net share settlement.

a. EDS's Failure to Disclose Material Information Regarding Its Derivatives Contracts

i. *EDS's Failure to Disclose the Status of the Derivatives Contracts in its Form 10-Q for the Quarter Ended March 31, 2002*

EDS's Form 10-Q for the quarter ended March 31, 2002 failed to comply with the disclosure requirements of Item 303(b) of Regulation S-K by failing to include any mention of the derivatives contracts. At the time that EDS filed its first quarter Form 10-Q, it expected the aggregate cost of EDS shares to be purchased under these derivatives contracts to be over $265 million. This was material to EDS's financial condition, including its liquidity, at that time. By failing to disclose the status of its derivatives contracts in this filing, EDS violated Exchange Act Section 13(a) and Rule 13a-13 thereunder.

ii. *EDS's Failure to Disclose the Status of the Derivatives Contracts in its Form 10-Q for the Quarter Ended June 30, 2002*

EDS's Form 10-Q for the quarter ended June 30, 2002 also failed to comply with the disclosure requirements of Item 303(b) of Regulation S-K. At the time that EDS filed its second quarter Form 10-Q, it expected the cost of shares to be purchased under these derivatives contracts to be $317 million. Though EDS included some disclosures regarding the derivatives contracts in that filing, they were ambiguous and incomplete in that they failed to disclose adequately EDS' $317 million obligation under the derivatives contracts; the manner in which EDS intended to settle the derivatives contracts; and that it could be accelerated due to a precipitous drop in EDS's share price. By failing to comply with Item 303(b) of Regulation S-K, EDS violated Exchange Act Section 13(a) and Rule 13a-13 thereunder.

EDS's Form 10-Q for the quarter ended June 30, 2002 also failed to comply with EITF 00-19's disclosure requirements. EDS did not disclose adequately the derivatives contracts' current fair values or the maximum number of shares it could be required to issue in a net share settlement. In addition, by failing to make any mention of the trigger provisions, EDS failed to disclose how changes in its stock price would affect its contracts' current fair values. EDS's failures to include this information as required by EITF 00-19 caused it to violate Exchange Act Section 13(a) and Rule 13a-13 thereunder.

b. EDS's Failure to Comply with Regulation FD

Regulation FD prohibits the selective disclosure of material nonpublic information to securities professionals. Issuers violate Regulation FD when they, or a person acting on their behalf, disclose material nonpublic information to securities analysts or other enumerated persons without making public disclosure of that information, simultaneously for intentional disclosures, or promptly for non-intentional disclosures. 17 C.F.R. § 243.100. *See also* Final Rule: Selective Disclosure and Insider Trading, Exchange Act Release No. 34-43154, 65 Fed. Reg. 51,716 (Aug. 15, 2000) ("Adopting Release"). An issuer's failure to make a required public disclosure pursuant to Regulation FD constitutes violations of both Regulation FD and Section 13(a) of the Exchange Act. *See* Adopting Release, 65 Fed. Reg. at 51726.

Information is nonpublic if it has not been disseminated in a manner making it available to investors generally. *See, e.g., SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 854 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969). "Information becomes public when disclosed 'to achieve a broad dissemination to the investing public generally and without favoring any special person or group.'" *SEC v. Mayhew*, 121 F.3d 44, 50 (2d Cir. 1997) (citations omitted).

Although the $225 million payment to settle the derivatives contracts did not directly affect EDS's earnings, it was nevertheless material to EDS at that time. EDS personnel disclosed the $225 million payment to settle the derivatives contracts to securities analysts on September 19, 2002 and September 23, 2002. EDS did not disclose publicly until September 24, 2002 that it had closed out its position in these obligations through the issuance of commercial paper, and did not publicly disclose the $225 million cost of the settlement until November 14, 2002. Consequently, EDS violated Regulation FD and Section 13(a) of the Exchange Act.

c. EDS's Failure to Disclose Material Information Regarding its Cash Flow in its Form 10-Q for the Quarter Ended June 30, 2002

In its Form 10-Q for the quarter ended June 30, 2002, EDS did not adequately disclose the basis that led it to report a large one-time boost to its free cash flow. The reference to "an increase in deferred revenue due to an increase in customer prepayments" was insufficient to convey the extraordinary nature of the $200 million prepayment. By not providing additional information regarding the terms of the advance, this disclosure suggested that EDS's improving cash flow was a consequence of ordinary business operations. EDS consequently violated Exchange Act Section 13(a) and Rules 12b-20 and 13a-13 thereunder.

2. Violations of the Books and Records Provisions of the Exchange Act

Section 13(b)(2)(A) of the Exchange Act requires every Section 12 registrant to "make and keep books, records, and accounts which, in reasonable detail, accurately and fairly reflect" the issuer's transactions. The Commission need not prove *scienter* to establish violations of Exchange Act Section 13(b)(2). *See* "Promotion of the Reliability of Financial Information and Prevention of the Concealment of Questionable or Illegal Corporate Payments and Practices," Exchange Act Rel.

No. 34-15570 (Feb. 15, 1979). "[A]ccurate recordkeeping is an essential ingredient in promoting management responsibility and is an affirmative requirement for publicly held American corporations to strengthen the accuracy of corporate books and records, which are 'the bedrock elements of our system of corporate disclosure and accountability.'" *SEC v. World-Wide Coin Investments, Ltd., et al.*, 567 F. Supp. 724, 746 (N.D. Ga. 1983) (citations omitted).

a. EDS's Books and Records Violations Relating to the NMCI Contract

In the first and second quarters of 2002, EDS prepared NMCI contract accounting models reflecting that it would deploy 160,000 seats during the five-year contract term. At the time these models were employed, EDS had an insufficient basis to assume that only 160,000 seats would be deployed over the life of the contract. For this reason, EDS's books, records and accounts did not, in reasonable detail, accurately and fairly reflect the status of the NMCI contract. Consequently, EDS violated Exhange Act Section 13(b)(2)(A).

b. EDS's Books and Records Violations Relating to ATKI

The false invoicing scheme described above caused ATKI to make and keep inaccurate books, records and accounts, and consequently caused EDS to violate Exchange Act Section 13(b)(2)(A).

EDS's Remedial Efforts

In determining to accept the Offer, the Commission considered remedial acts promptly undertaken by Respondent and cooperation afforded the Commission staff in connection with its books and records violations related to ATKI.

IV.

In view of the foregoing, the Commission deems it appropriate to accept EDS's Offer.

Accordingly, it is hereby ORDERED:

Respondent EDS cease and desist from committing or causing any violations and any future violations of Sections 13(a) and 13(b)(2)(A) of the Exchange Act, and Rules 12b-20, 13a-13, and Regulation FD thereunder.

Respondent, in connection with its books and records violations related to ATKI, shall, within fifteen (15) days of the entry of this Order, pay disgorgement in the amount of $358,800, and prejudgment interest thereon in the amount of $132,102, for a total payment of $490,902 to the United States Treasury. This payment shall be: (A) made by United States postal money order, certified check, bank cashier's check or bank money order; (B) made payable to the Securities and Exchange Commission; (C) hand-delivered or mailed to the Office of Financial Management, Securities and Exchange Commission, Operations Center, 6432 General Green Way, Stop 0-3, Alexandria, VA 22312; and (D) submitted under cover letter that identifies EDS as a Respondent in these proceedings and the file number of these proceedings. A copy of the cover letter and money order or check shall be sent to Kenneth R. Lench, Assistant Director, Division of Enforcement, Securities and Exchange Commission, 100 F Street N.E., Washington, DC 20549-6041.

By the Commission.

Nancy M. Morris
Secretary