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UNITED STATES DISTRICT COURT

NORTHERN DISTRICT OF CALIFORNIA

SAN JOSE DIVISION

JF

RS

CV 08 5127

SECURITIES AND EXCHANGE COMMISSION, Plaintiff, v. BLUE COAT SYSTEMS, INC. and ROBERT P. VERHEECKE, Defendants.	Case No. ________________ **COMPLAINT**

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

SUMMARY OF THE ACTION

1. From at least 2000 through 2005, Blue Coat Systems, Inc. ("Blue Coat" or the "Company"), a Sunnyvale network security company, illegally backdated stock options granted to Blue Coat employees and executives, concealing tens of millions of dollars in expenses from the Company's shareholders. Company Chief Financial Officer Robert P. Verheecke at various times

used hindsight to pick dates corresponding to low stock prices for stock option grants, prepared or distributed misleading documents that made it appear as if the options had been granted on the earlier dates, and prepared or approved financial statements and SEC filings that omitted necessary expenses for backdated options and falsely described Blue Coat's option granting practices.

2. Well-settled accounting principles required Blue Coat, during the relevant time, to record an expense in its financial statements when it granted stock options to employees and officers "in-the-money" – i.e., with an exercise price below the fair market value of the stock on the grant date. By contrast, Blue Coat was not required to record compensation expense when it granted options "at-the-money" – with an exercise price equal to the fair market value of the stock. Blue Coat's backdating enabled it to attract and retain talent by giving lucrative "in-the-money" options without recording an expense.

3. As a result of the backdating, Blue Coat's financial statements and SEC filings were materially misstated. In March 2007, after an internal investigation, Blue Coat restated and adjusted its financial statements for fiscal years 2000 through 2005. It recorded nearly $50 million in additional stock compensation charges for misdated option grants, resulting in material decreases to Blue Coat's operating and net income.

4. Blue Coat and Verheecke violated the antifraud, internal controls, books-and-records, and other provisions of the federal securities laws. The Commission seeks an order enjoining Blue Coat and Verheecke from future violations and requiring Verheecke to pay civil monetary penalties, barring him from serving as an officer or director of a public company, and providing other relief.

JURISDICTION, VENUE, AND INTRADISTRICT ASSIGMENT

5. The Commission brings this action pursuant to Sections 20(b) and 20(d) of the Securities Act of 1933 ("Securities Act") [15 U.S.C. §§ 77t(b) and 77t(d)] and Sections 21(d) and 21(e) of the Securities Exchange Act of 1934 ("Exchange Act") [15 U.S.C. §§ 78u(d) and 78u(e)].

6. This Court has jurisdiction over this action pursuant to Sections 20(b) and 22(a) of the Securities Act [15 U.S.C. §§ 77t(b) and 77v(a)] and Sections 21(d), 21(e), and 27 of the Exchange Act [15 U.S.C. §§ 78u(d), 78u(e), and 78aa].

7. Venue is proper in this District pursuant to Section 22 of the Securities Act [15 U.S.C. § 77v] and Section 27 of the Exchange Act [15 U.S.C. § 78aa]. Blue Coat's principal place of business is in the Northern District of California. Verheecke resides in this District. Acts or transactions constituting the alleged violations occurred in this District.

8. Blue Coat and Verheecke, directly or indirectly, made use of the means or instrumentalities of interstate commerce, or of the mails, or of the facilities of a national securities exchange in connection with the alleged transaction, acts, practices, and courses of business.

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

DEFENDANTS

10. Blue Coat is a Delaware corporation with headquarters in Sunnyvale, California. The Company makes appliances to secure and monitor computer networks. It went public in November 1999 as CacheFlow, Inc., changing its name to Blue Coat in 2002 (for ease of reference, this complaint uses exclusively the term "Blue Coat" or "Company"). At all relevant times, its common stock was registered with the Commission pursuant to Section 12(g) of the Exchange Act. Until August 20, 2002, Blue Coat shares traded on the Nasdaq National Market under the symbol "CFLO"; thereafter, they traded under the symbol "BCSI." Blue Coat's fiscal year ends each year on April 30.

11. Robert P. Verheecke, age 56, resides in Palo Alto, California. He served as Blue Coat's senior vice president, CFO, and secretary from May 2001 through May 2005; he continued to work on special projects for Blue Coat until January 2006. Verheecke obtained his California Certified Public Accountant license in 1977, although it was inactive during his tenure at Blue Coat. Before joining Blue Coat, Verheecke was an auditor at the accounting firm Price Waterhouse LLP from 1979 to 1983. He served as CFO of NetFRAME Systems, Inc. from 1998 to 1993 and Business Objects, S.A. from 1994 to 1997. He also has served as CFO of several private technology companies.

FACTUAL ALLEGATIONS

A. Blue Coat Used Stock Options to Recruit and Retain Talent

12. Throughout the relevant period, Blue Coat, like other technology companies with which it competed, used stock options as a form of compensation to recruit, reward, and retain key employees and officers. Each option gave the recipient the right to buy Blue Coat common stock from the Company at a set price, called the "exercise" or "strike" price, on a future date after the option vested. The option was "at-the-money" when granted if the closing price of Blue Coat's common stock on the date of the grant and the exercise price were the same. The option was "in-the-money" when granted if the closing price of Blue Coat common stock on the date of the grant exceeded the option's exercise price.

13. Stock options were particularly important to Blue Coat. The company completed its initial public offering in November 1999, but after a few quarters of dramatic revenue growth (peaking at approximately $33 million for the quarter ended October 31, 2000), it began experiencing significant difficulties. Its revenue plummeted by more than 50%, its stock price collapsed, and it was forced to terminate approximately two-thirds of its employees. In early to mid-2001, several key employees resigned, including its CFO, controller, vice president of sales, and general counsel. It became imperative for Blue Coat to control expenses and conserve cash. Stock options were an effective means to compensate employees and officers without a cash expenditure.

B. Blue Coat Told Investors It Granted Stock Options at Fair Market Value

14. Under Accounting Principles Board Opinion No. 25, "*Accounting for Stock Issued to Employees*" ("APB 25"), and the accounting rules in effect during Blue Coat's fiscal years 2000 through 2005, public companies were required to record an expense in their financial statements for the in-the-money portion of an option grant. APB 25 mandated that difference had to be recorded as a compensation expense recognized over the vesting period of the option. Consequently, granting in-the-money options could have a significant impact on the expenses and income (or loss) reported to the shareholders of a public company. APB 25 allowed companies, where the key terms of an option

grant were known, to grant stock options without recording any compensation expense so long as the option exercise price was not below the stock's market price on the grant date.

15. In annual reports on Form 10-K for fiscal years 2000 through 2005, filed with the SEC and made available to investors, Blue Coat represented that it accounted for stock options in accordance with APB 25. For example, for fiscal 2003, it stated: "We account for stock based awards . . . using the intrinsic value method . . . . Under the intrinsic value method, when the exercise price of the Company's employee stock options equals the market price of the underlying stock on the date of grant, no compensation expense is recognized as prescribed by [APB 25]."

16. Blue Coat's annual reports also disclosed to investors that the company recorded deferred stock compensation when the exercise price for stock options differed from the market price on the grant date. For example, in a report on Form 10-K for fiscal 2003, Blue Coat stated: "Our deferred stock compensation balance generally represents the difference between the exercise price and the market price of the underlying stock on the date stock options are granted to employees."

17. In certain annual reports – for fiscal years 2002 and 2003 – Blue Coat stated that it recorded no deferred stock compensation, adding that it may in the future "if management decides to grant below-market stock options."

18. Blue Coat made similar representations in quarterly reports on Form 10-Q between 2000 and 2005 filed with the SEC and made available to investors. Blue Coat's quarterly reports on Form 10-Q filed in fiscal 2002 represented that "[o]ur stock compensation balance generally represents the difference between the exercise price and the deemed fair value of stock options and warrants granted to employees . . . on the date such stock awards were granted." Its report for the quarter ended January 31, 2003, stated that "we continue to apply the rules for stock-based compensation contained in [APB 25] using the intrinsic value method." In addition, the reports filed in fiscal 2004 and 2005 represented that "[w]e account for stock-based awards granted to . . . employees and officers using the intrinsic value method . . . . [W]hen the exercise price of our employee stock options equals the market price of the underlying stock on the date of grant, no compensation expense is recognized."