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2009 MAY 14 PM 2:43

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CENTRAL DISTRICT OF CALIF.
LOS ANGELES

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11
12 UNITED STATES DISTRICT COURT
13 CENTRAL DISTRICT OF CALIFORNIA

14
15 SECURITIES AND EXCHANGE
16 COMMISSION,

17 Plaintiff,

18 vs.

19 GARY A. RAY,

20 Defendant.
21
22

Case No.

CV09-3430

R

(CTx)

COMPLAINT

23 1. From at least 1999 through 2005, Gary A. Ray, the former executive
24 vice president of human resources of KB Home, Inc. ("KB Home" or the
25 "Company"), enriched himself and others at the Company by using hindsight to
26 pick advantageous grant dates for KB Home's annual stock option grants, which
27 on many occasions coincided with dates of low monthly closing prices for the
28 Company's common stock. As a result, KB Home made annual grants of

1 undisclosed in-the-money stock options to its officers and employees that were not
2 accurately reported in the Company's records. Finally, because of the backdating
3 scheme, KB Home filed periodic reports and proxy statements with the Securities
4 and Exchange Commission (the "Commission"), which inaccurately stated that KB
5 Home granted options at fair-market-value on the date of the grant.

6 2. Ray received backdated annual stock option awards amounting to
7 380,000 shares of KB Home stock. Ray exercised many of these options and
8 profited more than \$480,000 from the improper backdating.

9 3. By engaging in the acts alleged in this Complaint, Ray, among other
10 things, violated, or aided and abetted violations of, the antifraud, books and records,
11 and reporting provisions of the federal securities laws. The Commission seeks an
12 order imposing an officer-and-director bar and enjoining Ray from future violations
13 of the securities laws, requiring him to disgorge ill-gotten gains, pay prejudgment
14 interest, and pay a civil monetary penalty.

15 **JURISDICTION AND VENUE**

16 4. This Court has jurisdiction over this action pursuant to Sections 21(d),
17 21(e), and 27 of the Securities Exchange Act of 1934 ("Exchange Act"), 15 U.S.C.
18 §§ 78u(d), 78u(e), and 78aa. Ray, directly or indirectly, made use of the means or
19 instrumentalities of interstate commerce, of the mails, or of the facilities of a
20 national securities exchange in connection with the transactions, acts, practices,
21 and courses of business alleged in this Complaint.

22 5. Venue is proper in this district pursuant to Section 27 of the Exchange
23 Act, 15 U.S.C. § 78aa, because Ray resided within this district during the relevant
24 time period and certain of the transactions, acts, practices, and courses of conduct
25 constituting violations of the laws alleged in this Complaint occurred within this
26 district.

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1 **1999-2001 Annual Grants**

2 11. For the three annual grants between 1999 and 2001, KB Home
3 employees reviewed KB Home's historical stock prices between the compensation
4 committee meeting date and the end of the fiscal year on November 30 to find the
5 date with the lowest stock price. Ray and the CEO then either approved or
6 selected that date as the grant date for the annual option award.

7 12. The grant date that Ray and the CEO either approved or selected for
8 each of the 1999, 2000, and 2001 annual grants coincided with KB Home's lowest
9 stock price between the compensation committee meeting date in each of those
10 years and the end of each fiscal year.

11 **2002-2005 Annual Grants**

12 13. In April 2002, Congress passed the Sarbanes-Oxley Act ("SOX").
13 Among other things, SOX changed the reporting rules for Section 16 officers by
14 requiring that any change in stock ownership, including the receipt of stock
15 options, be reported on Commission Form 4 "before the end of the second business
16 day, following the day on which the subject transaction has been executed."

17 14. In October 2002, in light of this new requirement and to ensure the
18 timely filing of Forms 4, KB Home's in-house legal counsel recommended to Ray
19 that KB Home use a "fixed date" rather than a "play it out" strategy when selecting
20 the grant date for annual option grants.

21 15. Ray discussed the advice from the in-house legal counsel with the
22 CEO, who ultimately approved the "play it out" strategy. This strategy involved
23 using hindsight to select the annual grant dates, although SOX's Form 4 filing
24 requirements prevented Ray and the CEO from looking back several weeks when
25 selecting the grant date for annual option awards.

26 16. Between 2002 and 2005, Ray and others at KB Home tracked the
27 Company's stock price after the compensation committee meeting, waiting for a
28 downward trend. Once a downward trend was identified, Ray and others at KB

1 Home reviewed the stock price over the previous three business days. Ray then
2 recommended to the CEO the date with the lowest price as the grant date for the
3 Company's annual stock option grant. As a result, Ray and others at KB Home
4 received undisclosed in-the-money option grants while still filing timely Forms 4.

5 17. On October 2, 2003, the compensation committee met and approved
6 the fiscal year 2004 annual option grants, including a grant of 22,400 options that
7 were granted to Ray. On Tuesday, October 28, Ray received an email from
8 another HR employee stating, "unless we dip further, we'll use Friday's price of
9 \$66.47 for the FY2004 grants. We'll check back in with you after the market
10 closes." Because the stock price on the three business days between October 24
11 and October 28 was the lowest on Friday, October 24, Ray and the CEO selected
12 that day as the grant date for the annual option awards. By using October 24 as the
13 grant date, Ray's options were in-the-money by \$36,512.

14 18. On October 7, 2004, the compensation committee met and approved
15 the option grants, including 15,000 options that were granted to Ray. Following
16 the meeting, Ray and the CEO watched KB Home's stock price until Monday,
17 October 25, when Ray wrote an email to an HR employee stating, "I'm going to
18 talk to [the CEO] today about using Friday, 10/22, as the strike price date
19 (\$76.50)." Because the stock price on Friday, October 22 was lower than the stock
20 price on Monday, October 25, Ray and the CEO selected Friday, October 22 as the
21 grant date. By using hindsight on October 25 to select October 22 as the grant
22 date, Ray's options were in-the-money by \$36,000.

23 19. On October 6, 2005, the compensation committee met and approved
24 the option grants, including 4,000 options that were granted to Ray. On Friday,
25 October 7, Ray informed the CEO in an email that the option grants for FY 2006
26 were complete and everything was ready to "pull the trigger." In the email, Ray
27 reminded the CEO, "(Given the 36 hour filing requirement, we have until close of
28 market Monday [October 10] to use yesterday's [October 6] price.) We can

1 determine how the week starts, see if there is any backlash [to the stock price from
2 an unflattering television story about KB Home], and either launch with
3 yesterday's closing price or wait."

4 20. On October 14, Ray emailed the CEO asking, "Do you want to let
5 next week play or do you want to go with yesterday?" The CEO responded, "Let's
6 see what happens this week." On Wednesday, October 19, Ray emailed the CEO
7 asking, "Do you want me to lock on yesterday?" The price on October 18 was
8 \$62.34, and the price on October 19 was \$65.29. Because the stock price was
9 lower, Ray and the CEO selected October 18 as the annual grant date. By looking
10 back only one day and selecting October 18 as the grant date, Ray's options were
11 in-the-money by \$11,800.

12 **B. Ray Hides His Backdating Conduct**

13 21. In mid-2006, the media began focusing on stock option backdating.
14 Due to media scrutiny of KB Home's unusually advantageous option grant dates,
15 the chief legal officer ("CLO") at KB Home began a review of the Company's
16 stock option practices. The results of this review were to be provided to KB
17 Home's audit committee in a written report (the "Report").

18 22. Upon learning of the CLO's review and that the Report would be
19 provided to KB Home's audit committee, Ray met with the CEO to discuss what
20 information they would provide to the CLO. Ray and the CEO crafted an
21 innocent, yet false, explanation for the backdating of annual option grants from
22 1999 through 2005 and provided that explanation to the CLO.

23 23. In interviews with the CLO, Ray repeatedly stated that the stock
24 options process was not manipulated in any way and that hindsight had not been
25 used to select annual option grant dates. Ray explained to the CLO that the
26 selection of the grant date was not price-driven, but instead related to the
27 completion of the allocation of the pool of options to lower-level employees. Ray
28 also told the CLO that after the allocation process was completed, the grant date

1 was mechanically determined on a going-forward basis – either immediately or
2 within a couple of days.

3 24. The CLO relied heavily on the statements from Ray in drafting the
4 Report, which Ray reviewed and commented on before it was provided to the audit
5 committee. Among other things, a draft of the Report concluded that KB Home
6 did not backdate annual option grants from 1999 through 2005. After reviewing
7 the draft, Ray failed to correct this false conclusion. On June 14, 2006, the Report
8 was delivered to the audit committee.

9 25. After completion of the Report, Ray learned from KB Home’s outside
10 counsel that even employing a one-day “look-back” when selecting a stock option
11 grant date is improper and would have accounting consequences.

12 **C. KB Home’s Misleading Second Quarter 2006 Form 10-Q**

13 26. On July 7, 2006, KB Home filed a Form 10-Q with the Commission,
14 which made no mention of the CLO’s review of the Company’s stock option
15 practices, or that the Company’s annual grants from 1999 through 2006 were
16 backdated. In the weeks leading up to the filing, KB Home’s deputy general
17 counsel raised concerns with senior executives about whether the Form 10-Q
18 should address the Company’s stock option inquiry. Specifically, he proposed to
19 delay the filing pending an independent investigation of KB Home’s option
20 granting practices, or that KB Home disclose in the filing that the company
21 intended to retain outside counsel to conduct an independent investigation.

22 27. Ray was aware of these proposals but failed to inform the CLO, the
23 deputy general counsel, outside counsel, finance personnel, KB Home’s auditors,
24 or the audit committee that he and the CEO routinely backdated the annual option
25 grants. Ray also knew that the CLO and others relied upon the false
26 representations Ray and the CEO made during the CLO’s review in deciding not to
27 disclose KB Home’s internal option probe in the second quarter Form 10-Q. In
28 fact, on the day the Form 10-Q was filed, the CLO reiterated in an email to the

1 deputy general counsel that any disclosure of KB Home's potential option
2 backdating issues was unnecessary because, among other things, "the company
3 does not believe that ... there has been backdating or other manipulation of option
4 grants by management." Ray received this email and remained silent, preventing
5 the Company from making accurate disclosure in the second quarter Form 10-Q.

6 **D. Ray Causes KB Home to File Materially False and Misleading Proxy**
7 **Statements**

8 28. Between February 8, 2000 and March 6, 2006, KB Home filed six
9 proxy statements. As KB Home's vice president of human resources, Ray's
10 responsibilities included reviewing and approving the executive compensation
11 portion of KB Home's proxy statements. Among other things, that portion of the
12 proxy statements falsely stated, "All options were granted at market value on the
13 date of grant." Ray and the CEO routinely backdated KB Home's annual grants
14 and knew that this disclosure was false because options were not granted at market
15 value on the date of the grant. Each proxy also falsely disclosed the backdated
16 grant date for Ray's annual option awards.

17 **E. Ray Benefits From the Scheme**

18 29. Between 1999 and 2005, through annual option awards, Ray received
19 options to purchase approximately 380,000 shares of KB Home common stock.
20 Ray, or his assigns, exercised options he received in 1999, 2000, and 2001 and
21 thereby acquired 190,000 shares. Upon selling these shares, Ray realized in-the-
22 money benefits of \$483,100.

23 **F. KB Home's False Books and Records and Inadequate Accounting**
24 **Controls and Ray's Falsification of Books and Records**

25 30. Ray played a central role in options backdating at KB Home. He
26 participated in the determination of the final option amounts distributed to lower-
27 level employees and, in conjunction with the CEO, either recommended or selected
28 the grant date for annual option awards.

1 31. By virtue of Ray's conduct, KB Home's books and records
2 inaccurately reflected, among other things, option grant dates and exercise prices.

3 32. Ray failed to maintain KB Home's system of controls by, among
4 other things, systematically backdating annual option grants to himself and others
5 from 1999 to 2005.

6 33. Ray also falsified KB Home's books and records when he caused a
7 false report regarding KB Home's stock option granting practices to be provided to
8 the Company's audit committee in connection with the CLO's internal review.

9 **FIRST CLAIM FOR RELIEF**

10 **FRAUD IN CONNECTION WITH THE PURCHASE OR SALE OF**
11 **SECURITIES**

12 **Violations of Section 10(b) of the Exchange Act**
13 **and Rule 10b-5 Thereunder**

14 34. The Commission realleges and incorporates by reference ¶¶ 1 through
15 33 above.

16 35. Ray, by engaging in the conduct described above, directly or
17 indirectly, in connection with the purchase or sale of a security, by the use of
18 means or instrumentalities of interstate commerce, of the mails, or of the facilities
19 of a national securities exchange, knowingly or recklessly:

- 20 a. employed devices, schemes, or artifices to defraud;
- 21 b. made untrue statements of a material fact or omitted to state a
22 material fact necessary in order to make the statements made, in
23 light of the circumstances under which they were made, not
24 misleading; or
- 25 c. engaged in acts, practices or courses of business which operated
26 or would operate as a fraud or deceit upon other persons.

27 36. By engaging in the conduct described above, Ray violated, and unless
28 restrained and enjoined will continue to violate, Section 10(b) of the Exchange

1 Act, 15 U.S.C. § 78j(b), and Rule 10b-5 thereunder, 17 C.F.R. § 240.10b-5.

2 **SECOND CLAIM FOR RELIEF**

3 **FALSIFYING BOOKS AND RECORDS OR CIRCUMVENTING**

4 **INTERNAL ACCOUNTING CONTROLS**

5 **Violations of Section 13(b)(5) of the Exchange Act**

6 37. The Commission realleges and incorporates by reference ¶¶ 1 through
7 33 above.

8 38. By the conduct alleged above, Ray violated Section 13(b)(5) of the
9 Exchange Act, 15 U.S.C. § 78m(b)(5), which prohibits any person from knowingly
10 circumventing a system of internal accounting controls or knowingly falsifying
11 certain books, records, and accounts.

12 39. By engaging in the conduct described above, Ray violated and, unless
13 restrained and enjoined, will continue to violate Section 13(b)(5) of the Exchange
14 Act, 15 U.S.C. § 78m(b)(5).

15 **THIRD CLAIM FOR RELIEF**

16 **EQUITY BENEFICIAL OWNERSHIP REPORTING VIOLATION**

17 **Violations of Section 16(a) of the Exchange Act and Rule 16a-3 Thereunder**

18 40. The Commission realleges and incorporates by reference ¶¶ 1 through
19 33 above.

20 41. Section 16(a) of the Exchange Act, 15 U.S.C. § 78p(a), and Rule 16a-
21 3 thereunder, 17 C.F.R. § 240.16a-3, require that any person that directly or
22 indirectly beneficially owns more than 10% of a company's class of stock
23 registered under Section 12 of the Exchange Act, 15 U.S.C. § 78l, must notify the
24 Commission within 10 days of the acquisition. Additionally, Section 16(a) of the
25 Exchange Act requires that if there has been a change of such ownership during a
26 month, the reporting persons shall file with the Commission a statement indicating
27 their ownership at the end of the calendar month and the changes in that ownership
28 that occurred during the month. Exchange Act Rule 16a-3 requires that statements

1 of changes in beneficial ownership be filed on Form 4.

2 42. By engaging in the conduct described above, Ray violated, and unless
3 restrained and enjoined will continue to violate, Section 16(a) of the Exchange Act,
4 15 U.S.C. § 78p(a), and Rule 16a-3 thereunder, 17 C.F.R. § 240.16a-3.

5 **FOURTH CLAIM FOR RELIEF**

6 **FALSIFICATION OF RECORDS**

7 **Violations of Exchange Act Rule 13b2-1**

8 43. The Commission realleges and incorporates by reference ¶¶ 1 through
9 33 above.

10 44. Ray, directly or indirectly, falsified or caused to be falsified KB
11 Home's books, records and accounts subject to Section 13(b)(2)(A) of the
12 Exchange Act, 15 U.S.C. § 78m(b)(2)(A).

13 45. By engaging in the conduct alleged above, Ray violated, and unless
14 restrained and enjoined will continue to violate, Exchange Act Rule 13b2-1, 17
15 C.F.R. § 240.13b2-1.

16 **FIFTH CLAIM FOR RELIEF**

17 **VIOLATIONS OF COMMISSION PERIODIC REPORTING**

18 **REQUIREMENTS**

19 **Aiding and Abetting Violations of Section 13(a) of the Exchange Act, and**
20 **Rules 12b-20 and 13a-13 Thereunder**

21 46. The Commission realleges and incorporates by reference ¶¶ 1 through
22 33 above.

23 47. KB Home violated Section 13(a) of the Exchange Act, 15 U.S.C. §
24 78m(a), and Rules 12b-20 and 13a-13, 17 C.F.R. §§ 240.12b-20 and 240.13a-13,
25 thereunder, by filing with the Commission a materially false and misleading Form
26 10-Q for the second quarter of 2006.

27 48. Ray knowingly provided substantial assistance to KB Home's
28 violation of Section 13(a) of the Exchange Act, 15 U.S.C. § 78m(a), and Rules

1 12b-20 and 13a-13, 17 C.F.R. §§ 240.12b-20 and 240.13a-13, thereunder.

2 49. By engaging in the conduct described above and pursuant to Section
3 20(e) of the Exchange Act, 15 U.S.C. § 78t(e), Ray aided and abetted KB Home's
4 violations, and unless restrained and enjoined will continue to aid and abet
5 violations, of Section 13(a) of the Exchange Act, 15 U.S.C. § 78m(a), and Rules
6 12b-20 and 13a-13, 17 C.F.R. §§ 240.12b-20 and 240.13a-13, thereunder.

7 **SIXTH CLAIM FOR RELIEF**

8 **RECORD-KEEPING VIOLATIONS**

9 **Aiding and Abetting Violations of Section 13(b)(2)(A) of the Exchange Act**

10 50. The Commission realleges and incorporates by reference ¶¶ 1 through
11 33 above.

12 51. KB Home violated Section 13(b)(2)(A) of the Exchange Act, 15
13 U.S.C. § 78m(b)(2)(A), by failing to make or keep books, records, and accounts
14 that in reasonable detail accurately and fairly reflected its transactions and
15 disposition of its assets.

16 52. Ray knowingly provided substantial assistance to KB Home's
17 violation of Section 13(b)(2)(A) of the Exchange Act, 15 U.S.C. § 78m(b)(2)(A).

18 53. By engaging in the conduct described above and pursuant to Section
19 20(e) of the Exchange Act, 15 U.S.C. § 78t(e), Ray aided and abetted KB Home's
20 violations, and unless restrained and enjoined will continue to aid and abet
21 violations, of Section 13(b)(2)(A) of the Exchange Act, 15 U.S.C. § 78m(b)(2)(A).

22 **SEVENTH CLAIM FOR RELIEF**

23 **INTERNAL CONTROLS VIOLATIONS**

24 **Aiding and Abetting Violations of Sections 13(b)(2)(B) of the Exchange Act**

25 54. The Commission realleges and incorporates by reference ¶¶ 1 through
26 33 above.

27 55. KB Home violated Section 13(b)(2)(B) of the Exchange Act, 15
28 U.S.C. § 78m(b)(2)(B), which obligates issuers of securities registered pursuant to

1 Section 12 of the Exchange Act, 15 U.S.C. § 78l, to devise and maintain a
2 sufficient system of internal accounting controls.

3 56. Ray knowingly provided substantial assistance to KB Home's
4 violation of Section 13(b)(2)(B) of the Exchange Act, 15 U.S.C. § 78m(b)(2)(B).

5 57. By engaging in the conduct described above and pursuant to Section
6 20(e) of the Exchange Act, 15 U.S.C. § 78t(e), Ray aided and abetted KB Home's
7 violations, and unless restrained and enjoined will continue to aid and abet
8 violations, of Section 13(b)(2)(B) of the Exchange Act, 15 U.S.C. § 78m(b)(2)(B).

9 **EIGHTH CLAIM FOR RELIEF**

10 **FALSE PROXY STATEMENTS**

11 **Aiding and Abetting Violations of Section 14(a) of the Exchange Act**
12 **and Rule 14a-9 Thereunder**

13 58. The Commission realleges and incorporates by reference ¶¶ 1 through
14 33 above.

15 59. KB Home issued false proxy solicitations from February 8, 2000
16 through March 6, 2006, in violation of Section 14(a) of the Exchange Act, 15
17 U.S.C. § 78n(a), and Rule 14a-9 thereunder, 17 C.F.R. § 240.14a-9, which prohibit
18 solicitations by means of a proxy statement, form of proxy, notice of meeting, or
19 other communications, written or oral, containing statements which, at the time
20 and in light of the circumstances under which they were made, were false and
21 misleading with respect to material facts, or omitted to state material facts
22 necessary in order to make the statements therein not false or misleading or
23 necessary to correct statements in earlier communications with respect to the
24 solicitation of the proxy for the same meeting or subject matter which was false or
25 misleading.

26 60. Ray knowingly provided substantial assistance to KB Home's false
27 proxy solicitations.

28 61. By engaging in the conduct described above and pursuant to Section

1 20(e) of the Exchange Act, 15 U.S.C. § 78t(e), Ray aided and abetted KB Home's
2 violations, and unless restrained and enjoined will continue to aid and abet
3 violations, of Section 14(a) of the Exchange Act, 15 U.S.C. § 78n(a), and Rule
4 14a-9 thereunder, 17 C.F.R. § 240.14a-9.

5 **PRAYER FOR RELIEF**

6 WHEREFORE, the Commission respectfully requests that the Court:

7 (a) Issue findings of fact and conclusions of law that Ray committed the
8 violations alleged and charged herein.

9 (b) Issue judgments, in a form consistent with Rule 65(d) of the Federal
10 Rules of Civil Procedure, permanently enjoining Ray, his agents, servants,
11 employees, attorneys, and those persons in active concert or participation with him,
12 who receive actual notice of the order by personal service or otherwise, from
13 violating Sections 10(b), 13(b)(5), and 16(a) of the Exchange Act, 15 U.S.C. §§
14 78j(b), 78m(b)(5), 78p(a), and Rules 10b-5, 13b2-1, and 16a-3 thereunder, 17
15 C.F.R. §§ 240.10b-5, 240.13b2-1, and 240.16a-3, and from aiding and abetting
16 violations of Sections 13(a), 13(b)(2)(A), 13(b)(2)(B), and 14(a) of the Exchange
17 Act, 15 U.S.C. §§ 78m(a), 78m(b)(2)(A), and 78m(b)(2)(B), 78n(a) and Rules 12b-
18 20, 13a-13, and 14a-9 thereunder, 17 C.F.R. §§ 240.12b-20, 240.13a-13, and
19 240.14a-9.

20 (c) Order Ray to disgorge all ill-gotten gains from his illegal conduct,
21 together with prejudgment interest thereon.

22 (d) Order Ray to pay civil penalties pursuant to Section 21(d)(3) of the
23 Exchange Act, 15 U.S.C. § 78u(d)(3).

24 (e) Enter an order, pursuant to Section 21(d)(2) of the Exchange Act, 15
25 U.S.C. § 78u(d)(2), prohibiting Ray from serving as an officer or director of any
26 issuer that has a class of securities registered with the Commission pursuant to
27 Section 12 of the Exchange Act, 15 U.S.C. § 78l, or that is required to file reports
28 pursuant to Section 15(d) of the Exchange Act, 15 U.S.C. § 78o(d).

1 (f) Retain jurisdiction of this action in accordance with the principles of
2 equity and the Federal Rules of Civil Procedure in order to implement and carry
3 out the terms of all orders and decrees that may be entered, or to entertain any
4 suitable application or motion for additional relief within the jurisdiction of this
5 Court.

6 (g) Grant such other and further relief as this Court may determine to be
7 just and necessary.

8
9 DATED: May 14, 2009

Respectfully submitted,

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11 
12 JESSICA R. PUATHASNANON
13 Attorney for Plaintiff
14 Securities and Exchange Commission
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