

July 2006

## First Enforcement Actions Taken On Stock Option Backdating Cases

### The First Stock Option Backdating Cases

The Securities and Exchange Commission and the U.S. Attorney for the Northern District of California held a joint news conference on July 20, 2006 announcing the filing of civil and criminal charges in the first enforcement actions concerning the practice of backdating stock options. Simply stated, backdating of stock options occurs when the grant date of the stock option is earlier than the date on which the grant is actually made, typically to take advantage of a lower stock price on a prior date.

The cases against the former CEO, President and Chairman of Brocade Communications Systems, Inc. and the company's former VP of Human Resources are based on several instances of backdating options and the falsification of company books and records to conceal their actions from auditors, shareholders and the public.

### Enforcement Trends

It is widely acknowledged that the SEC and DOJ are actively investigating stock option practices. In fact, the SEC is investigating more than 80 companies with respect to their stock option practices, and a recent study indicates that more than 2,000 companies may have used backdated stock options, which puts them at risk for similar inquiries and investigations.

Backdating stock options raises a host of issues depending on the surrounding facts and circumstances:

- "Springloading" Issues – grant prior to disclosure of good news or immediately after the announcement of bad news
- Disclosure Issues

- Accounting Issues
- Reporting Issues
- SOX Certification Issues
- Tax Law Issues
- D&O Insurance Issues
- Investor Relations Issues

### Areas of Possible Exposure to Companies and Individuals

- SEC – Civil Enforcement Actions
- DOJ – Criminal Enforcement Actions
- FBI – Investigations
- IRS – Civil and Criminal Enforcement Investigations
- Class Actions
- Derivative Actions
- Possible Liability for Individual Directors and Officers

### Protecting Your Company

In view of the active ongoing investigations and potential civil and criminal exposure to companies and their directors and officers, we suggest each company consider examining with legal counsel their stock option grant history and practices, as well as their internal controls.

For further information see PWMA Blog [www.SECActions.com](http://www.SECActions.com), posting June 12, 2006 "Two Current Enforcement Priorities: Options and Medical Information"

This *Securities Law Alert* is prepared for the general information of clients and friends and should not be relied upon as specific legal advice. Please contact your attorney about your particular situation. If you do not have an attorney, you can contact one of the attorneys listed below for more information about these issues:

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