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9 UNITED STATES DISTRICT COURT
10 NORTHERN DISTRICT OF CALIFORNIA
11 SAN JOSE DIVISION

12		
13	SECURITIES AND EXCHANGE COMMISSION,	Civil Action No.
14	Plaintiff,	
15	vs.	COMPLAINT
16	GREGORY L. REYES, ANTONIO CANOVA, and STEPHANIE JENSEN,	
17	Defendants.	
18		

19
20 Plaintiff Securities and Exchange Commission (the "Commission") alleges:

21 **SUMMARY OF THE ACTION**

22 1. From at least 2000 through 2004, executives of Brocade Communications Systems,
23 Inc. ("Brocade" or "the Company"), a San Jose computer networking company, concealed millions of
24 dollars in expenses from investors, and significantly overstated the Company's income, by falsifying
25 records relating to employee stock option grants. The fraudulent scheme was orchestrated by former
26 chief executive officer Gregory L. Reyes, who routinely executed backdated documents and evaded
27 rules requiring Brocade to publicly report these compensation expenses.

28

1 and 78aa. The defendants, directly or indirectly, have 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 7. 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 defendants may be found in this district.

8 INTRADISTRICT ASSIGNMENT

9 8. Assignment to the San Jose Division is appropriate pursuant to Civil Local Rule 3-
10 2(e) because a substantial part of the events that give rise to the Commission's claims occurred in
11 Santa Clara County.

12 DEFENDANTS

13 9. Defendant Gregory L. Reyes, 43, is a resident of Saratoga, California. Reyes joined
14 Brocade as its president and chief executive officer ("CEO") in May 1998, and became a member of
15 its board of directors in July 1998. In May 2001, Reyes took on the additional role of chairman of
16 Brocade's board of directors. On approximately January 24, 2005, Reyes was succeeded as CEO and
17 chairman of the board by another executive, while Reyes continued as a director and an advisor until
18 he left the Company in July 2005. From 2001 through the present, Reyes has also served on the
19 boards of directors of other publicly traded technology companies.

20 10. Defendant Antonio Canova, 44, is a resident of Los Altos Hills, California. Canova
21 joined Brocade in December 2000 and served as Brocade's chief financial officer ("CFO") and vice
22 president of finance, from May 2001 until he resigned from the Company in December 2005. Canova
23 is licensed as a certified public accountant in California.

24 11. Defendant Stephanie Jensen, 48, is a resident of Los Altos, California. Jensen served
25 as Brocade's vice president of human resources from October 1999 until February 2004. She worked
26 as a consultant to Brocade from February 2004 until August 2004, when she retired from Brocade.

1 RELEVANT ENTITY

2 12. Brocade Communications Systems, Inc. is a Delaware corporation based in San Jose,
3 California, that develops and sells storage networking products. Since May 1999 when it completed
4 its initial public offering of stock, Brocade's securities have been traded on the Nasdaq National
5 Market, and the Company has had common stock registered with the Commission under Section
6 12(g) of the Exchange Act. At all times relevant to this action, Brocade used a fiscal year ending on
7 the last Saturday in October.

8 FACTUAL ALLEGATIONS

9 **A. Reyes Caused Brocade to Misrepresent the Company's Employee Stock Option Program**

10 13. Brocade became a public company in May 1999 and quickly experienced substantial
11 growth in revenues and in the size of its operation. Between October 1999 and October 2002
12 Brocade increased the size of its workforce by more than six-fold, hiring over 1,150 employees.
13 Reyes was extremely concerned with recruiting employees in what he considered to be a competitive
14 market and informed Brocade's board of directors that he considered attracting and retaining top
15 talent to be one of the most important aspects of his job as CEO.

16 14. To recruit and retain key employees, Brocade made liberal use of employee stock
17 options as a form of compensation. The stock options gave employees the right to buy Brocade's
18 stock at a set price, called the exercise price or "strike" price. The value of the options to the
19 employees increased to the extent the market price of Brocade's stock exceeded the strike price of the
20 options.

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

1 reported to the shareholders of a public company. The accounting rules also specified that a company
2 must recognize compensation expense if it granted options to a non-employee.

3 16. As a public company, Brocade filed with the Commission annual reports that included
4 audited financial statements, certified by the Company's outside auditors. Brocade's public filings
5 affirmatively stated that the Company accounted for its stock options granted to employees in
6 accordance with generally accepted accounting principles, also known as GAAP, which are the
7 accounting conventions, standards, and rules required for preparing financial statements. GAAP
8 required an expense to be recorded for stock options granted at prices below the market value for the
9 stock on the date of the grant. Brocade made the statements about accounting for stock options in
10 accordance with GAAP in the notes to its audited financial statements, included in its annual reports
11 to shareholders, filed with the Commission on Form 10-K, for its fiscal years 2000, 2001, 2002 and
12 2003. Also, Brocade's annual report filed on Form 10-K for fiscal year 2003 represented that,
13 following this rule, the Company did not record any expense for stock options because the strike price
14 for the options granted always equaled the trading price on the date of grants. Reyes reviewed and
15 signed each of the above Forms 10-K that made this false representation, and also certified the Forms
16 10-K for fiscal years 2002 and 2003. Canova similarly reviewed and signed the Forms 10-K for fiscal
17 years 2001, 2002 and 2003 making this false representation, and certified those for fiscal years 2002
18 and 2003.

19 17. The same claim, that Brocade accounted for its stock options granted to employees in
20 accordance with GAAP, and that no compensation expense was recorded, was also stated in the notes
21 to the unaudited financial statements included with each of its quarterly reports filed on Form 10-Q
22 for the quarters ended April 26, 2003, July 26, 2003, January 24, 2004, May 1, 2004, and July 31,
23 2004. Reyes signed a certification stating, among other things, that he had reviewed the Forms 10-Q
24 for these periods and he was not aware of any material misstatements of fact or omissions in those
25 filings. Canova also signed and certified each of the Forms 10-Q for these periods.

26 18. The representations to Brocade's shareholders in its annual and quarterly filings about
27 the Company's stock option program were untrue. Reyes knew those statements were untrue,
28 because he engineered a scheme to falsify the documentation for options grants to employees to make

1 it appear as though Brocade was not required to record an expense for its options. In particular, to
2 evade the consequences of granting options to employees “in-the-money,” Reyes signed falsely dated
3 options grants to make it appear as though the options had been granted at the market price on an
4 earlier date.

5 19. As more fully described below, Reyes enlisted other employees, including Jensen, in
6 his scheme to falsify the documentation of Brocade’s options grants. Reyes also counted on the
7 complicity of other persons, including Canova, who learned of the scheme but nevertheless permitted
8 false statements to the public and to the Company’s shareholders in Brocade’s filings to be made.

9 **B. Reyes’ Scheme to Backdate Option Grants**

10 20. After Brocade became a public company, Brocade’s board of directors had in place
11 stock option plans, including a plan under which Reyes was given the authority to grant stock options
12 to employees (other than certain officers and directors), as the sole member of a “Compensation
13 Committee” that acted as the “Administrator” of the plan.

14 21. During the period beginning no later than 2000 through 2004, Reyes used the
15 authority delegated to him to choose when to grant options to non-officer employees, as well as how
16 many options to grant. During this period, Reyes used the virtually unchecked authority given to him
17 to grant “in-the-money” options to employees by falsifying in the options documentation the date on
18 which the grants were made and thereby granting the options with below-market strike prices.

19 22. To carry out the options grant scheme, Reyes directed Jensen to prepare
20 documentation of the options grants to employees for his signature. In particular, Jensen provided
21 Reyes with a list (by name of employee, number of options, hire date for new hires, and other
22 information) of options granted at a purported “Compensation Committee Meeting” occurring on a
23 given date. Reyes signed the documentation for each such grant, attesting that he, as the sole member
24 of the Compensation Committee meeting on that date, had granted the options to the specified
25 persons on that date.

26 23. Jensen and others also supplied Reyes with Brocade’s stock price history over a
27 period of time in which she, or others, highlighted the lowest closing price during the period, which
28 was at times as long as three months. The documentation supplied by Jensen purported to specify the

1 date on which the Compensation Committee meeting occurred; in reality the date specified was
2 simply the date selected from Brocade's stock price history because it was the lowest (or nearly) in
3 the period.

4 24. In fact, as Reyes and Jensen both knew, Reyes had not granted the options on the date
5 set forth in the options grant. Instead, at a later date when the market price was higher, Reyes and
6 Jensen backdated the grant documentation to an earlier date, using hindsight, to make it appear that
7 the options had been granted on the earlier date.

8 25. Reyes and Jensen then provided the minutes of the purported Compensation
9 Committee meeting that documented the options grant to other persons at Brocade who were
10 responsible for recording the grant in Brocade's books and records and preparing the Company's
11 financial statements. As Reyes and Jensen further knew, because they supplied documentation that
12 falsely represented the options were granted on an earlier date and that the exercise price for the
13 grants was the earlier market value, the Company did not record an expense related to the grants in its
14 financial statements.

15 26. On at least nine occasions between January 2, 2001 and July 2, 2002, Reyes
16 backdated options grants to provide employees with "in-the-money" options while evading the
17 requirement that Brocade incur a compensation expense related to those grants. Those grants were
18 backdated as of the following dates: January 2, 2001, April 17, 2001, July 23, 2001, October 1, 2001,
19 October 30, 2001, November 28, 2001, January 22, 2002, February 28, 2002, and July 2, 2002.

20 27. Indeed, during the 10 consecutive fiscal quarters beginning with Brocade's third
21 quarter ended July 31, 2000, through the fourth quarter ended October 26, 2002, Brocade granted
22 stock options to employees at the quarterly low stock price in 8 of the 10 quarters, and with exercise
23 prices near the quarterly low in the other two quarters. See Appendix A.

24 28. Reyes' scheme to backdate stock options continued during 2003 and 2004.
25 Beginning in mid-August 2003, Reyes granted options to employees on a more frequent basis than he
26 had previously. As a result, Jensen and others began providing Reyes with information showing
27 Brocade's stock price history, and its low closing stock price, over a period of approximately a week.

1 29. On at least six occasions between August 15, 2003 and October 20, 2004, Reyes
2 backdated options grants to provide employees with “in-the-money” options while evading the
3 requirement that Brocade incur a compensation expense related to those grants. Those grants were
4 backdated as of the following dates: August 15, 2003, October 20, 2003, January 22, 2004, February
5 26, 2004, March 22, 2004, and June 21, 2004.

6 30. Indeed, during Brocade’s five consecutive fiscal quarters beginning with the quarter
7 ended October 26, 2003, through the quarter ended October 30, 2004, Reyes made 32 option grants.
8 Of those grants, 19 grants to over 1,000 employees (granting options to purchase a total of
9 approximately 16 million shares), were priced at the weekly low closing price for Brocade’s stock and
10 for an additional three grants, within just \$0.03 of the weekly low. See Appendix A.

11 **C. Reyes’ Backdating Scheme Caused Brocade to Falsely Report Financial Results**

12 31. The options backdating scheme caused Brocade to materially misstate its financial
13 results during the period beginning no later than 2000 through 2004. Reyes knew the applicable
14 accounting rules. He spoke frequently, within the Company, with persons outside of Brocade, and
15 publicly, about the rules requiring public companies to record an expense for “in-the-money” options
16 grants. Reyes sought to evade the requirement by falsifying the dates, aware that the Company relied
17 on the falsified options documentation to prepare its financial statements.

18 32. Jensen also understood that accounting rules required that Brocade record an expense
19 for options granted to employees that were “in-the-money,” as she had been instructed or advised
20 regarding the rules by persons at the Company and by Brocade’s outside auditors and consultants.
21 She falsified the options documentation, and related records, aware that the Company relied on the
22 falsified options documentation to prepare its financial statements.

23 33. Thus, during the period from 2000 through 2004, using the Compensation Committee
24 Meeting minutes supplied to them by Jensen or persons working at her direction, persons working in
25 Brocade’s finance department recorded the information into Brocade’s books and records
26 immediately upon receiving the Compensation Committee Meeting minutes. From those books and
27 records, the persons in the finance department incorporated the grants into Brocade’s financial
28 statements.

1 34. The finance department personnel also checked the grant documentation against other
2 information supplied by Jensen or persons working at her direction. In particular, for newly hired
3 employees, the options grants were compared against documentation of the employees' start dates as
4 evidenced in offer letters. However, since Jensen and persons working at her direction had also
5 falsified those documents, the backdating went undetected and Brocade failed to record any
6 compensation expense related to the backdated options grants.

7 35. Brocade also provided the same documentation about grant dates and employee hiring
8 to the Company's external auditors in connection with their annual audits of Brocade's financial
9 statements. Relying on the false documentation supplied to them, Brocade's auditors concurred with
10 the Company's assessment that no compensation expense should be recorded for the options granted
11 to employees.

12 36. Based on the false and misleading information recorded in its books and records,
13 Brocade filed and publicly announced materially false and misleading financial results for its fiscal
14 years 2000, 2001, 2002, 2003, and publicly announced materially false and misleading financial
15 results for fiscal year 2004. Late in 2004, the Audit Committee of Brocade's board of directors began
16 to investigate allegations by a former employee who claimed to have been issued back-dated options.

17 37. During the course of the Audit Committee's investigation, Brocade announced on
18 January 24, 2005 (and later filed in its January 31, 2005 Form 10-K) restated financial results
19 previously announced for 1999 through 2004, to record expenses for options grants to employees.
20 The restated results had the following impact: (1) net loss for the 2004 fiscal year increased from \$1.3
21 million to \$32 million (i.e., net loss was understated by 95.9%); (2) net loss for fiscal year 2003
22 increased from \$136 million to \$146 million; (3) net income for fiscal year 2002 increased from \$60
23 million to \$126 million; and (4) income for fiscal years 1999 through 2001 declined by a total of \$303
24 million.

25 38. On May 16, 2005, the Company announced a further restatement (filed on amended
26 Form 10-K dated November 22, 2005) to include additional stock-based compensation expense of
27 \$0.9 million related to options grants between August 2003 and November 2004.
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