Bank and Corporate Governance Law Reporter
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Recent Developments

SEC Brings First Regulation G Enforcement Action

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The Securities and Exchange Commission recently filed its first civil enforcement action under Regulation G, alleging that a public company intentionally misclassified certain ordinary operating expenses as nonrecurring expenses in order to increase its earnings. *SEC v. SafeNet, Inc*., Litig. Rel. No. 21290 (Nov. 12, 2009). Regulation G provides that, if a public company discloses material information that includes a financial measure not calculated in conformity with generally accepted accounting principles (GAAP), the company must reconcile the non-GAAP financial measure to the most directly comparable GAAP financial measure. Regulation G also prohibits public companies from disseminating false or misleading non-GAAP financial measures or presenting non-GAAP financial measures in a manner that would mislead investors or obscure the company's GAAP results.

The SEC alleged that the company failed to comply with Regulation G by making improper adjustments to the company's expenses. The improper adjustments allegedly included reclassifying ordinary expenses as nonrecurring integration expenses, reducing accruals for professional fees and reducing inventory reserve accruals. According to the SEC's complaint, these adjustments were made without factual support in order to inflate the company's earnings, and the company provided false and misleading explanations to its independent auditors when the auditors questioned the adjustments. The SEC complaint also alleged that former corporate officers and internal accountants engaged in a fraudulent scheme to backdate stock option grants without recording the requisite compensation expense for the option grants and used improper accounting adjustments to achieve earnings targets.

Without admitting or denying the allegations, the defendants settled the action with the SEC. As part of that settlement, the company agreed to pay a civil penalty of $1,000,000 and consented to a judgment permanently enjoining it from violating Regulation G and the antifraud provisions of the federal securities laws. The individual defendants also paid civil penalties. The settlement with the SEC took into account the company's and the individuals' cooperation with the SEC's investigation.

Many public companies disclose non-GAAP financial measures because they believe that such information is useful to investors. The SEC's recent enforcement action should not be viewed as prohibiting the disclosure of non-GAAP financial measures that comply with Regulation G. However, companies that report non-GAAP financial measures should ensure that they can explain why such financial measures are helpful to investors; have adequate factual support for such financial measures; and can accurately reconcile such financial measures to their GAAP results to the extent required by Regulation G. Companies also need to make sure that the use of non-GAAP financial measures will not be viewed in hindsight as misleading investors or otherwise obscuring financial results reported in accordance with GAAP.

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Corporate Governance Provisions Added to Financial Reform Bill

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Senator Dodd unveiled his 1,136-page financial reform bill discussion draft today[1], which proposes a variety of new financial industry regulations

1 This memo was originally released on November 10, 2009.

