

**SEC BRINGS FIRST REGULATION G ENFORCEMENT ACTION**

The SEC recently announced its first enforcement action under Regulation G.<sup>1</sup> In the complaint, filed against SafeNet, Inc. and certain former executives and accountants, the SEC alleged that SafeNet fraudulently engaged in earnings management, causing SafeNet to materially misstate its financial results and condition. As part of the complaint, the SEC alleged that the defendants improperly characterized certain operating expenses as non-recurring integration expenses to justify their exclusion from the company's non-GAAP financial results in violation of Regulation G. Without admitting or denying the allegations, the defendants agreed to a consent decree and to pay certain civil penalties.

As directed by Section 402(b) of the Sarbanes-Oxley Act, Regulation G imposes restrictions on the public disclosure by reporting companies of "non-GAAP financial measures."<sup>2</sup> Regulation G prohibits companies from disseminating false or misleading non-GAAP financial measures or presenting the non-GAAP financial measures in such a manner that they mislead investors or obscure the company's GAAP results. Regulation G requires companies to reconcile the non-GAAP financial measure to the most directly comparable GAAP financial measure and also, in their SEC reports, to explain why such non-GAAP financial presentation provides useful information to investors.

According to the SEC complaint, the executives manipulated SafeNet's GAAP and non-GAAP financial results as part of their scheme to ensure that SafeNet met its quarterly earnings per share (EPS) targets. The SEC alleged that the executives:

- reclassified certain ordinary operating expenses (including marketing expenses and Sarbanes-Oxley compliance costs) as non-recurring integration expenses;
- improperly reduced accruals for certain professional fees; and
- improperly reduced certain inventory reserve accruals.

Having characterized these operating expenses as "non-recurring" or "one-time" integration expenses, SafeNet proceeded to exclude them in its non-GAAP EPS calculation. Even amounts that, at its auditors' insistence, it was not allowed to characterize as integration expenses, it excluded from its non-GAAP presentation by creating and excluding new categories of non-recurring expenses.

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<sup>1</sup> See "SEC Charges SafeNet, Inc. and Two Former Senior Officers in Earnings Management and Options Backdating Schemes," Litigation Release No. 21290 (November 12, 2009), available at <http://www.sec.gov/litigation/litreleases/2009/lr21290.htm>. The complaint is available at <http://www.sec.gov/litigation/complaints/2009/comp21290.pdf>.

<sup>2</sup> As defined in Rule 101(a)(1) of Regulation G, a "non-GAAP financial measure" excludes amounts that are included in the most directly comparable GAAP measure presented in the issuer's financial statements or, conversely, includes amounts excluded from the issuer's comparable GAAP measure.

*Commentary:*

- The SEC complaint repeatedly emphasizes that the defendants’ disclosures were materially false and misleading. Thus, even in the absence of Regulation G, it is likely that the SEC would have proceeded with the causes of action under Exchange Act Rule 10b-5 and other securities laws violations.
- Particularly in light of this SEC enforcement action, companies should ensure that their non-GAAP disclosures strictly comply with Regulation G, including providing the requisite reconciliation and explaining, in “non-boilerplate” fashion, why such presentation provides information useful to investors. As noted by the SEC in the SafeNet complaint, any adjustments or reclassifications and related assumptions should be documented, with appropriate accounting support.
- Companies should be careful not to characterize excluded items as non-recurring, infrequent or unusual where the nature of the charge is such that it is reasonably likely that it will reoccur within the next two years or there was a similar charge within the prior two years. Companies that want to exclude such charges (i.e., where not identified as unusual) must meet a heightened burden of demonstrating the usefulness of such measure.<sup>3</sup> It is likely that such items should also be discussed in the company’s Management’s Discussion and Analysis.
- At the same time, companies should not refrain from using non-GAAP financial measures when appropriate. Over recent years, in somewhat of an overreaction to the numerous abuses of the use of non-GAAP measures to manipulate financial results, the SEC has taken a restrictive view of what non-GAAP financial measures can be provided in an SEC report. This approach has had the unfortunate result of companies excluding information that they believe is useful to investors and has led, in certain instances, to a two-tiered reporting system, where information that management considers important is relegated to press releases and is not included in the SEC reports. At recent securities conferences, Meredith Cross, the Director of the SEC Division of Corporation Finance, and Wayne Carnall, the Chief Accountant of the Division of Corporation Finance, both acknowledged this problem and noted that they have asked the SEC staff to review their interpretive guidance so as not to discourage appropriate non-GAAP financial presentations.

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<sup>3</sup> See Item 10(e)(ii)(B) of Regulation S-K and Questions 8 and 9 of the related SEC FAQs.

If you have any questions regarding Regulation G or this recent enforcement action, please contact Jeffrey S. Hochman (212-728-8592, [jhochman@willkie.com](mailto:jhochman@willkie.com)), Robert B. Stebbins (212-728-8736, [rstebbins@willkie.com](mailto:rstebbins@willkie.com)), or the Willkie attorney with whom you regularly work.

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