

Securities Law ADVISORY

November 24, 2009

SEC Brings First Enforcement Action Pursuant to Regulation G

The Securities and Exchange Commission (SEC) recently announced its first enforcement action for violations of Regulation G since its enactment in 2003, in which the SEC simultaneously filed and settled a civil injunctive action against SafeNet, Inc. and a number of its former officers and accountants.¹ The SEC alleged that, during the period from the fourth quarter of 2000 through May 2006, SafeNet engaged in earnings management that resulted in SafeNet reporting materially misleading GAAP and non-GAAP financial results.

Regulation G

Under Regulation G, if a company chooses to disclose a non-GAAP measure, it must reconcile the non-GAAP financial measure to the most directly comparable GAAP financial measure. Non-GAAP measures are often used to exclude non-recurring, infrequent, unusual or non-cash expenses, so as to provide comparable performance measures across multiple financial reporting periods. Regulation G also prohibits companies and their employees from disseminating false or misleading non-GAAP financial measures or presenting the non-GAAP financial measures in such a manner that would mislead investors or obscure the company's GAAP results.

The SEC's Allegations and Settlement

In its complaint, the SEC alleged that SafeNet engaged in a scheme to meet or exceed quarterly earnings per share (EPS) targets through the use of improper accounting adjustments, such as classifying ordinary operating expenses as non-recurring integration expenses (costs incurred to integrate acquired companies into current operations) and improper reductions of accruals and reserves. According to the SEC, these actions resulted in the company's reporting materially misleading GAAP and non-GAAP financial results. The SEC also alleged that former officers and accounting personnel fraudulently backdated option grants without recording the appropriate compensation expense and used improper accounting adjustments to achieve earnings targets.

Without admitting or denying the allegations in the complaint, SafeNet consented to the entry of a judgment and a permanent injunction from violating the antifraud provisions of the federal securities laws, and was ordered to pay a civil penalty of \$1 million. The former officers also consented to permanent injunctions, disgorgement and civil penalties.

¹ <http://www.sec.gov/litigation/litreleases/2009/lr21290.htm>

Implications

This enforcement action is another signal that the SEC and its staff are willing to use all the enforcement tools at their disposal. This should not, however, discourage issuers from using non-GAAP financial measures, provided such measures accurately portray a company's financial performance.

Although this is the first enforcement case under Regulation G, it is not the first time the SEC has pursued a company for misrepresenting its financial performance using non-GAAP measures. In 2002 (prior to the adoption of Regulation G), the SEC issued a cease-and-desist order against Trump Hotels & Casinos for violations of the anti-fraud provisions of the Exchange Act.² The SEC issued the cease-and-desist order due to Trump Hotels' failure to disclose the impact of a one-time gain on its net income and for using pro-forma financial measures that did not give an accurate picture of its actual financial performance in accordance with GAAP.³ Thus, it is important that issuers keep in mind that the facts and circumstances surrounding a violation of Regulation G may also give rise to a Rule 10b-5 violation if all the elements for such a violation are present.

It is equally important, however, that issuers recognize that Regulation G imposes requirements in connection with the public communication of non-GAAP financial measures that do not rely solely on the anti-fraud regime. Regulation G independently prohibits material misstatements or omissions that would make the presentation of the material non-GAAP financial measure, under the circumstances in which it is made, misleading. In SafeNet, the SEC used both tools, specifically alleging that the company and former officers violated both Regulation G and the anti-fraud provisions contained in Rule 10b-5.

Increased Staff Focus

The staff of Corporation Finance routinely issues comments to issuers regarding their compliance with Regulation G. In addition, at several recent conferences, members of the staff have indicated that they are considering the need for additional guidance with respect to Regulation G to more clearly outline their expectations regarding the use of non-GAAP measures. Given this recent enforcement case, as well as the staff's increased focus on Regulation G, companies should ensure that they reconcile any non-GAAP measures to the most comparable GAAP measures, explain how the non-GAAP measures are used by management and why they are helpful to investors and ensure that they have sufficient documentation and other material to support the non-GAAP measures. In addition, companies should also remember Regulation G's counterpart in Item 10(e) of Regulation S-K, which addresses the use of non-GAAP financial measures where information is filed rather than furnished with the SEC and is also more restrictive in the presentation of non-GAAP measures.

² *In the Matter of Trump Hotels & Casino Resorts, Inc.*, Exchange Act Rel. No. 45287, Accounting & Auditing Enforcement Rel. No. 1499, <http://www.sec.gov/litigation/admin/34-45287.htm> (Jan. 16, 2002).

³ For a further discussion on the Trump Hotels enforcement matter, see Alston & Bird advisory: "SEC 'Pro Forma' Earnings Enforcement Action" (Jan. 2002), available at <http://www.alston.com/files/Publication/36d81be9-6388-4dfe-9919-16937874c3dd/Presentation/PublicationAttachment/d8dadf13-2284-4b1d-bee0-a4f7fc843758/SEC%20Pro%20Forma.pdf>.

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