



SEC Brings First Enforcement Proceeding Under Reg G for Improper Use of Non-GAAP Numbers

On November 12, 2009, the SEC announced that it has brought its first enforcement proceeding under Regulation G under the Securities Exchange Act of 1934 since its enactment in 2003.¹ Reg G, as it is commonly called, regulates the use by public companies of non-GAAP financial measures in public disclosures such as press releases, Web sites and conference calls. (The inclusion of non-GAAP numbers in SEC filings is subject to more rigorous requirements.)² Reg G essentially provides that: (1) references to a non-GAAP number must be reconciled to the most directly comparable GAAP number; and (2) a non-GAAP number may not be used in a way that results in a false statement of a material fact or omits to state a material fact necessary in order to make the presentation of the non-GAAP number not misleading under the circumstances under which it is presented. Companies commonly use non-GAAP financial measures such as “Adjusted EBITDA” in earnings press releases and conference calls to compare current period financial results with those of prior periods when the results of one of the periods (but not the other) were affected by one-time, non-recurring items such as income or expenses from acquired or divested companies, plant closings, employee terminations, or litigation settlements.

The SEC alleged that SafeNet, Inc.,³ through certain of its former officers and employees, sought to manage its earnings by re-classifying ordinary operating expenses so that its non-GAAP adjusted earnings information would meet quarterly earnings targets. In particular, the SEC alleged that SafeNet classified as “non-recurring” expenses — and therefore excluded from its non-GAAP earnings — certain expenses for ordinary operating items such as Sarbanes Oxley compliance, advertising, and employee salaries. For example, the SEC noted that SafeNet classified ordinary salary expenses for 60 employees as “non-recurring” on the grounds that the employees were to be terminated in a later period when in fact no decision had been made to terminate them when the non-GAAP numbers were released. The SEC charged that SafeNet’s CEO and CFO, in discussing these expenses on a conference call, misled securities analysts by not disclosing that the non-recurring salary expenses related to employees whom they “purportedly planned to terminate in future quarters.”⁴ The SEC named certain former employees of SafeNet on the grounds that they “prepared, reviewed and/or signed SafeNet’s materially misleading securities filings and press releases.”⁵ The SEC also charged SafeNet and certain individuals with engaging in a scheme to backdate stock options to increase their value to employees.

¹ SEC Litigation Release No. 21290 (November 12, 2009) (<http://www.sec.gov/litigation/litrelases/2009/lr21290.htm>).

² Item 10(e) of Regulation S-K under the Exchange Act adds requirements for the use of non-GAAP numbers in SEC filings. In particular, it provides that a company must not “adjust a non-GAAP performance measure to eliminate or smooth items identified as non-recurring, infrequent or unusual, when the nature of the charge or gain is such that it is reasonably likely to recur within two years or there was a similar charge or gain within the prior two years.”

³ Securities and Exchange Commission v. SafeNet, Inc., C.A. No. 1:2009cv02117 (D.D.C. filed November 12, 2009) (<http://www.sec.gov/litigation/complaints/2009/comp21290.pdf>).

⁴ Complaint at 30.

⁵ Complaint at 4.

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We do not believe the SEC's enforcement action regarding SafeNet's practices should discourage public companies from using non-GAAP numbers in press releases or conference calls. However, the SafeNet case is a timely reminder of the following: First, companies should not interpret the lack of Reg G enforcement proceedings since 2003 as evincing indifference on the part of the SEC toward Reg G violations. Second, even though Reg G permits the exclusion of "non-recurring" expenses in computing adjusted EBITDA and other non-GAAP financial measures, the SEC may bring an enforcement proceeding under Reg G if it believes, with the benefit of hindsight, that an excluded expense was not truly non-recurring. As a result, an aggressive judgment by an employee about whether an expense is non-recurring can result in a violation of Reg G. A conservative practice would be to apply to press releases and conference calls the SEC's standard for

SEC filings, namely, that an expense may not be characterized as "non-recurring" if the expense is reasonably likely to recur within two years or if there was a similar expense within the past two years.⁶ Third, the SafeNet case indicates that Reg G violations in combination with other factors can result in violations of the anti-fraud provisions of Section 17(a) of the Securities Act of 1933 and Rule 10b-5 under the Exchange Act. Fourth, public company executives should remember that Reg G also applies to oral statements made on conference calls and should not allow the informality of question-and-answer periods to result in inadvertent Reg G violations. Finally, the SEC's enforcement interest is not limited to companies; officers and employees who prepare or review press releases containing non-GAAP financial measures may face liability for Reg G violations.

⁶See note 2 *supra*.

If you have any questions regarding the matters discussed in this briefing, please contact any of the Winston & Strawn attorneys listed below or your usual Winston & Strawn contact.

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