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16 UNITED STATES DISTRICT COURT
17 NORTHERN DISTRICT OF CALIFORNIA
18 SAN FRANCISCO DIVISION

20 PRENA SMAJLAJ, individually and on behalf)
of all others similarly situated,)

22 Plaintiff,)

23 v.)

24 BROCADE COMMUNICATIONS SYSTEMS,))
INC, GREGORY L. REYES, AND ANTONIO)
25 CANOVA,)

26 Defendants.)
27)

Consolidated Case No.: 3:05-CV-02042-CRB

**CONSOLIDATED CLASS ACTION
COMPLAINT**

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1 Court-appointed Lead Plaintiff, the Arkansas Public Employees Retirement System
2 (“APERS”) (“Lead Plaintiff”), brings this federal securities law class action complaint
3 (“Complaint”) individually and on behalf of all other purchasers of common stock of Brocade
4 Communications Systems, Inc. (“Brocade” or the “Company”) between May 18, 2000 and May 15,
5 2005, inclusive (the “Class Period”), and alleges the following:¹

6 **I. INTRODUCTION**

7 1. Lead Plaintiff brings this action pursuant to §§ 10(b), 20A, and 20(a) of the
8 Securities Exchange Act of 1934 (the “Exchange Act”), 15 U.S.C. §§ 78j(b), 78t-1, and 78t(a), and
9 Rule 10b-5 promulgated thereunder (17 C.F.R. § 240.10b-5), on its own behalf and on behalf of all
10 other persons or entities who purchased or otherwise acquired Brocade common stock during the
11 Class Period. Defendants are Brocade; Brocade’s former Chief Executive Officer (“CEO”),
12 Gregory Reyes (“Reyes”); two of the Company’s former Chief Financial Officers (“CFO”), Michael
13 Byrd (“Byrd”), and Antonio Canova (“Canova”); its auditor, KPMG, L.L.P. (“KPMG”); and certain
14 members of Brocade’s Audit Committee. Brocade, Reyes, Byrd, Canova, KPMG, and the Audit
15 Committee members are collectively referred to as “Defendants” or individually as “Defendant.”

16 2. APERS asserts these claims on behalf of itself and a class consisting of all those who
17 purchased Brocade securities during the Class Period and who were damaged thereby (the “Class”).
18 Excluded from the Class are Defendants, the officers and directors of the Company at all relevant
19 times, members of their immediate families and their legal representatives, heirs, successors or
20 assigns and any entity in which Defendants have or had a controlling interest.

21
22
23 ¹ Lead Plaintiff’s allegations are based on information and belief, except as to those allegations
24 concerning Lead Plaintiff, which are based upon personal knowledge. Lead Plaintiff’s information
25 and belief is based upon, among other things: (a) the investigation conducted by and through its
26 attorneys; (b) review and analysis of filings made by Brocade with the United States Securities and
27 Exchange Commission (“SEC”); (c) review and analysis of press releases, public statements, news
28 articles, securities analysts’ reports and other publications disseminated by or concerning Brocade;
29 (d) interviews with former Brocade employees; and (e) other publicly available information about
30 Brocade. Most of the facts supporting the allegations contained herein are known only to
31 Defendants (defined herein) or are within their control. Lead Plaintiff believes that substantial
32 additional evidentiary support will exist for the allegations set forth herein after a reasonable
33 opportunity for discovery.

1 3. Publicly traded companies may, under certain specific circumstances, award their
2 employees stock option grants. A stock option grant gives an employee the right to purchase shares
3 of the company at a specific price (an “exercise price” or “strike price”) on or after a specific date.
4 For example, if a company gives an employee 100 options with an exercise price of \$10 per share,
5 this means that the employee can buy 100 shares for a total of \$1,000, irrespective of what the real
6 price of the Company’s stock is on the date the options are exercised.

7 4. When a company grants an employee stock options, it must do so under a written
8 stock option plan filed with the SEC and disclosed to the public. This is so because gains such as
9 the one described in the example above are a form of extra compensation and, therefore, may have
10 an impact on the company’s earnings per share, net income, compensation expenses, related tax
11 expenses, and other items. Thus, it is imperative that when a company awards option grants to its
12 employees, it do so in compliance with its publicly filed stock option plan and that it account for
13 such grants appropriately. Otherwise, investors will not have an accurate picture of the company’s
14 finances.

15 5. If a company’s stock option plan requires that (1) an option’s exercise price be tied
16 to the date of the grant and (2) that the date of the grant be the same date the employee starts
17 working at the company (as does Brocade’s Stock Option Plan) the date of the grant is of immense
18 importance. This is especially true if the company’s stock price is on the rise. Consider, for
19 example, Brocade’s stock price from May 24, 2000 through July 24, 2000. During this 60-day
20 period, Brocade’s common stock rose from \$94.00 on May 24, 2000 to \$159.50 on June 23, 2001 to
21 \$201.81 on July 24, 2000. Assuming that the Company gave a newly hired employee a stock
22 option grant of 100,000 shares with a start date of May 24, 2000, the employee’s exercise price for
23 her options would be \$94.00 per share. If the employee exercised those options on July 24, 2000,
24 when the Company’s stock price was up to \$201.81, she would make a profit of \$10,781,000.00.
25 However, if the employee’s option grant date did not occur until June 23, 2001, which was only 30
26 days later, her exercise price would be \$159.50 and her profit would be reduced to \$4,231,000.00.
27 Therefore, a change in the grant date of an employee’s stock options at Brocade of just 30 days at
28

1 the beginning of the Class Period could have a staggering impact on the value of those options—in
2 this example, a difference of \$6,530,000.00.

3 6. This is a case about one company, Brocade, and its officers, audit committee and
4 auditor, who engaged in a pervasive scheme whereby they violated the Company's publicly filed
5 plans for stock option grants in order to: (1) hire and retain employees without having to incur large
6 cash compensation expenses for high salaries; (2) hide the true impact that the cost of these option
7 grants had on the Company's earnings per share, net income, compensation expenses, and related
8 tax expenses; and (3) unilaterally grant themselves lucrative option grants. Brocade and its officers
9 carried out this scheme by, among other things: (1) using false start dates for employees so that they
10 could award options to these employees even though they had not actually started working for
11 Brocade; (2) using false dates regarding when the options were actually granted; (3) granting
12 options to employees purportedly on "leaves of absences" when such employees actually did not
13 even work for the Company yet; (4) manipulating the Company's stock option grant program in
14 order to allow Brocade's officers to secretly award massive stock option grants to themselves at the
15 most opportune and profitable times and prices; (5) backdating option grants in order to change
16 previously granted awards by giving them a lower and more favorable exercise price; (6) allowing
17 terminated employees to remain on a "leave of absence" so that unvested options could vest; and (7)
18 violating Generally Accepted Accounting Principles ("GAAP") by improperly accounting for and
19 disclosing the cost of such grants. None of these facts were ever disclosed to the public.

20 7. This scheme, and the false accounting that took place pursuant thereto, hid from
21 investors the negative impact of stock option grants upon the Company's earnings per share,
22 income, compensation expenses and related tax expenses. Brocade and its officers carried out this
23 scheme. KPMG and Brocade's Audit Committee allowed these officers to run roughshod over the
24 Company, in violation of the Company's own stock option plans. Even worse, KPMG and
25 Brocade's Audit Committee signed off on every false financial statement issued pursuant to this
26 scheme, all of which failed to disclose the true nature, scope and financial impact of the massive
27 option grants doled out under their scheme.

28

1 **B. Defendants**

2 **1. The Company**

3 11. Defendant Brocade designs, develops, markets, sells and supports data storage
4 networking products and services. Brocade was incorporated under the laws of Delaware in 1995,
5 with its principal executive offices located in San Jose, California. On or about May 24, 1999,
6 Brocade commenced an initial public offering of 3,250,000 of its shares of common stock at an
7 offering price of \$19 per share. During the Class Period, Brocade’s shares traded on the NASDAQ
8 under the symbol “BRCD.”

9 **2. The Officer Defendants: Reyes, Canova and Byrd**

10 12. Defendant Reyes was, from July 1998 to May 2001, Brocade's President and CEO.
11 In May 2001, Reyes expanded his role to Chairman and CEO. In January 2005, Reyes resigned
12 from his position as CEO and Chairman, remaining at the Company as a director and a consultant to
13 the Board and the new CEO.

14 13. Defendant Canova was, from 2000 to May 2001, Brocade's Vice President of
15 Finance. In May 2001, Canova’s role was expanded to CFO and Vice President, Administration.
16 On December 15, 2005, Canova resigned from his position as CFO and principal accounting officer
17 of the Company.

18 14. Defendant Byrd was, from April 20, 1999 to May 2001, Brocade’s Vice President of
19 Finance and Operations and CFO, and was President and Chief Operating Officer from May 2001
20 to 2003.

21 15. Defendants Reyes, Canova and Byrd are referred to individually by name or, when
22 referred to collectively, as the “Officer Defendants.”

23 **3. The Audit Committee Defendants: Neiman, Dempsey, Leslie, Sonsini, Paisley
24 and Moore**

25 16. Defendant Seth D. Neiman (“Neiman”) was a member of Brocade’s Board of
26 Directors (the “Board of Directors”), and was Chairman of the Board from August 1995 until May
27 2001. Neiman signed the Company’s Form 10-K for Fiscal Years 2000, 2001, 2002, 2003, 2004,
28

1 and 2005. Neiman served on the Audit Committee of Brocade’s Board of Directors from 2000
2 through 2001.

3 17. Defendant Neal Dempsey (“Dempsey”) was a member of the Board of Directors
4 since December 1996, served on Brocade’s Nominating and Corporate Governance Committee, and
5 served as Chairman of the Company’s Compensation Committee. Dempsey signed the Company’s
6 Form 10-K for Fiscal Years 2000, 2001, 2002, 2003, 2004 and 2005. Dempsey served on the Audit
7 Committee from 2000 through 2004.

8 18. Defendant Mark Leslie (“Leslie”) was a member of the Board of Directors until May
9 2002. Leslie signed the Company’s Form 10-K for Fiscal Years 2000 and 2001. Leslie served on
10 the Audit Committee in 2002.

11 19. Defendant Larry W. Sonsini (“Sonsini”) was a member of the Board of Directors
12 until March 2005. Sonsini signed the Company’s Form 10-K for Fiscal Years 2000, 2001, 2002,
13 2003 and 2004. Sonsini served on the Audit Committee from 2002 through 2003.

14 20. Defendant Christopher B. Paisley (“Paisley”) was a member of the Board of
15 Directors and signed the Company’s Form 10-K for Fiscal Years 2002, 2003, 2004 and 2005.
16 Paisley served on the Audit Committee from 2003 through 2005.

17 21. Defendant Nicholas G. Moore (“Moore”) was a member of the Board of Directors
18 and signed the Company’s Form 10-K for Fiscal Years 2003 and 2004. Moore served on the Audit
19 Committee from 2004 through 2005.

20 22. Defendants Neiman, Dempsey, Leslie, Sonsini, Paisley and Moore are referred to
21 collectively herein as the “Audit Committee Defendants.”

22 23. When referred to collectively, the Officer Defendants and the Audit Committee
23 Defendants are referred to herein as the “Individual Defendants.”

24 **4. Auditor Defendant: KPMG**

25 24. Defendant KPMG is a Delaware limited liability partnership headquartered in New
26 York City, New York. KPMG was directly involved in auditing Brocade and played an integral
27 part in the conduct, acts and omissions described below. KPMG provided auditing services to
28

1 Brocade for the years 2002 through 2004, including without limitation, conducting audits of the
2 Company’s year-end Financial Statements for those years.

3 **III. JURISDICTION AND VENUE**

4 25. The claims asserted herein arise under and pursuant to §§ 10(b) and 20(a) of the
5 Exchange Act and Rule 10b-5 promulgated thereunder.

6 26. This Court has jurisdiction over the subject matter of this action pursuant to 28
7 U.S.C. §§ 1331 and 1337, and § 27 of the Exchange Act.

8 27. Venue is proper in this District pursuant to § 27 of the Exchange Act and 28 U.S.C. §
9 1391(b). Many of the acts charged herein, including the preparation and dissemination of
10 materially false and misleading information, occurred in substantial part in this District and Brocade
11 conducts business in this District.

12 28. In connection with the acts alleged in this Complaint, Defendants, directly or
13 indirectly, used the means and instrumentalities of interstate commerce, including, but not limited
14 to, the mails, interstate telephone communications and the facilities of the national securities
15 markets.

16 **IV. BROCADE USED A PERVASIVE SCHEME WHEREBY IT IMPROPERLY**
17 **ISSUED MASSIVE STOCK OPTION GRANTS AND HID THE TRUTH REGARDING**
18 **THE NEGATIVE FINANCIAL IMPACT OF THIS SCHEME**

19 29. Defendants carried out this scheme as follows:

20 **A. Brocade’s 1999 Non-Statutory Stock Option Plan**

21 30. In September of 1999, Brocade’s Board of Directors approved the Company’s Non-
22 Statutory Stock Option Plan (“NSO Plan”). See Brocade’s SEC Form 10-K filed on January 31,
23 2005, p. 73 n.11. The NSO Plan provides for the grant of non-statutory stock options to employees
24 and consultants. *Id.* The NSO Plan was attached as Exhibit 10.8 to Brocade’s 1999 year-end SEC
25 Form 10-K and was operative at all times during the Class Period.

26 31. Pursuant to Paragraph 2(a) of the NSO Plan, the Plan “Administrator” is defined as
27 “the Board or any of its Committees as shall be administering the Plan.” *Id.* Thus, the Board was
28 charged with the duty to administer the Plan either by itself or by delegating such powers to distinct
committees. Pursuant to paragraph 4(a) of the NSO Plan, the Plan “shall be administered by the

1 Board or (ii) a Committee, which Committee shall be constituted to satisfy Applicable laws.” *Id.*
2 Paragraph 4(b)(i-vi) of the NSO Plan further gives the Board or Committee the sole authority to,
3 among other things, determine: (1) who may receive option grants, (2) the number of shares
4 granted by such options, and (3) the exercise price for such options. Further, pursuant to paragraph
5 4(x), the NSO Plan gives the Board or its Committee the power to authorize any person to execute
6 on behalf of the Company any instrument to effect the grant of an option previously granted by the
7 Board or Committee. Pursuant to the NSO Plan, the stated exercise price for non-qualified stock
8 options shall be no less than **85 percent of the estimated fair market value of common stock on**
9 **the date of the grant.** See Brocade’s SEC Form 10-K, filed January 31, 2005, p. 73 n.11 (emphasis
10 added).

11 32. As is set forth in detail below, Brocade’s Restatement, Defendant Reyes’ own
12 admissions, and the information provided by Lead Plaintiff’s confidential sources (the “Confidential
13 Sources”), all establish that Brocade, the Officer Defendants and the Audit Committee Defendants
14 knowingly or deliberately disregarded the express written requirements of the Company’s Stock
15 Option Plans and manipulated the dates upon which options were reported as granted under the
16 NSO Plan in order to strategically award grants at lower exercise prices in violation of GAAP and
17 federal securities laws. Their reasons for carrying out this scheme were fairly straightforward.

18 33. In the rapidly rising market for tech companies immediately preceding and during
19 the Class Period, the granting of stock options, particularly non-statutory options, was the
20 preeminent issue in the competition for skilled labor. Many workers in the industry, particularly
21 those working in the greater San Francisco Bay Area, were less concerned with their compensation,
22 than with the availability and particulars of stock option packages. As the Confidential Sources
23 explain below, competition for employees with the “right skill set” in the tech industry was fierce.
24 Throughout the early part of the Class Period, Brocade was short on cash to pay high salaries.
25 Thus, one of the only ways Brocade could obtain and retain attractive employees was to offer
26 lucrative stock option grants. Stock option grants were of equal, if not superior, importance than
27 salary to prospective employees, Brocade’s Officers, and the Company itself.

28

1 34. From the perspective of prospective employee recruits, if Brocade gave the
2 employee stock option grants with low exercise prices (“strike prices”) and then Brocade’s stock
3 went up high enough, the employee’s options would be “in the money.” The timing of stock option
4 grants was critical because: (1) Brocade’s stock price was rising dramatically on a daily basis
5 during the early part of the Class Period (and the strike price was tied to the Company’s stock price
6 on the date of the grant), and (2) the options could not be exercised until they became vested (which
7 was a process that occurred by vesting a percentage of the grant each year over a set period of time
8 until 100 percent of the grant became vested). If an option became vested, the employee could
9 exercise his or her options and collect the difference between the stock price and the exercise price,
10 which could mean great personal wealth.

11 35. From the perspective of Brocade, a new public start-up tech company, it needed to
12 use stock option grants to meet the demands of the labor market. Brocade was short on actual cash
13 to pay salaries and taxes but, at least from 2000 through 2004, was high on potential. The Officer
14 Defendants determined that they could manipulate the Company’s publicly filed Stock Option Plans
15 in order to hire new employees without expending great sums of cash. They also decided they
16 could mislead investors by hiding the negative impact these grants would have on the Company’s
17 Financial Statements (in the form of lower net income and earnings per share and higher
18 compensation expenses and related tax expenses).

19 36. From the perspective of the Officer Defendants, options were attractive for another
20 reason. They each knew that they could make themselves millions by combining their inside
21 knowledge of the Company with their ability to manipulate the Company’s stock option plans as
22 Officers of the Company. The Officer Defendants used the option process to selectively grant
23 themselves massive amounts of options whenever the stock price hit a low point and was primed to
24 rise again. Their reason in granting themselves options in this manner was simple: get the options
25 at the lowest exercise price possible. As explained in detail in Section V, *infra*, the Officer
26 Defendants granted themselves these options at unusually conspicuous times, in unusually
27 conspicuous amounts, and made millions in the process. Time and time again, these Defendants
28 granted themselves options at the most favorable price and on the most favorable date possible, just

1 moments before the stock price began to rise again. The timing of these grants was not the result of
2 a mere fortuity; it was done with intent.

3 37. Throughout the Class Period, the three Officer Defendants used all means necessary
4 to meet the seeming insatiable demands of employees for stock options and to make themselves
5 very rich. Brocade and the Officer Defendants carried out this scheme, while KPMG and the Audit
6 Committee stood by with deliberate recklessness in letting them do it. Indeed, the Officer
7 Defendants doled out options with utter disregard for the rules, Brocade's own Stock Option Plans,
8 or the effect these grants would have on its shareholders when the truth about Defendants' scheme
9 to manipulate the accounting for and disclosure of these grants was revealed to the investing public.
10 This led to systematic abuses at Brocade in its administering of and reported expensing of its stock-
11 based compensation systems.

12 38. For example, according to the Confidential Sources listed below, in order to make
13 option packages more attractive, Brocade's Executive Officers promulgated and carried out a
14 pervasive scheme whereby they would systematically back date option grants, give employees false
15 start dates, or sign an employee on as a current employee and then immediately place that employee
16 on a leave of absence (even though the employee was still actually working for another company),
17 so that Brocade could grant the employee options at the earliest date, and lowest exercise prices
18 possible. These practices were particularly important at a company like Brocade where, during
19 much of the Class Period, the stock price was steadily rising on a daily basis, and the exercise price
20 of options, which was tied to the market value of the Company's stock on the day of the grant,
21 could increase dramatically over a period as short as one day, thereby reducing the potential spread
22 between the exercise price and sales price.

23 39. Indeed, as evidenced by the daily stock price of Brocade throughout the Class
24 Period—as demonstrated in the charts below—Brocade's stock price rose rapidly, often gaining as
25 much as 50% in value over periods as short as 30 days, and was adjusted for by a 2:1 split three
26 times. For example: Brocade's stock rose from \$114 per share to \$206 per share between May 19,
27 2000 and July 18, 2000; from a split adjusted \$74 per share to \$108 per share from December 22,
28 2000 through January 29, 2000; and from a split adjusted \$20.33 per share to \$38.11 per share from

1 September 17, 2001 through December 22, 2001. During this time, according to the Confidential
2 Sources listed below, Brocade manipulated the start dates of new employees in order to grant
3 options at the earliest date possible in order to secure the lowest strike price, even though this
4 conduct violated the Company's own Stock Option Plans.

5 40. Lead Plaintiff has set forth specific detailed allegations regarding the Officer
6 Defendants' direct involvement in this scheme based upon numerous Confidential Sources (listed
7 below as "CS ____"). These allegations are set forth in full in Section VI.A, *infra*. A brief summary
8 of how some of these Confidential Sources described Reyes', Byrd's, and Canova's involvement in
9 this scheme, and how it operated, is as follows:

10 CS 1 became a full time Brocade employee in the Recruiting
11 Department in 2000. CS 1 described Brocade's procedures for
12 granting stock options to new employees. CS 1 was involved in
13 bringing in new hires and then giving them their offer letters, which
14 set forth the terms of the employment and compensation, including
15 stock options, being offered. According to CS 1, due to the
16 competitive job market during early 2000 through 2002, Brocade
17 needed to lure new employees by offering stock option grants. New
18 hires were concerned about the date the options would be granted
19 because the Company's stock price was rising on a daily basis.
20 Brocade was eager to use options to get these new employees to work
21 there. Brocade did not want to have to pay large salaries, however,
22 due to the large compensation costs. CS 1 described in detail the
23 methods used by Brocade to manipulate the Company's Stock Option
24 Plans. These methods included: backdating (giving a false, earlier
25 date than the actual date) the dates of offer letters and stock option
26 grant dates so that the new employees could take advantage of lower
27 exercise prices; placing favored employees on leaves of absences so
28 that their options could vest when they would not have if they had
simply been terminated or quit before the vesting date; giving
employees false start dates, so that their options could be granted by
ad hoc "Board meetings" even though the employee did not actually
work at Brocade yet; guaranteeing certain highly-recruited employees
specific gains on their option grants by backdating those grants so that
they would be "in the money"; and "repatriating" stock to the
Company so that it could then issue new option grants. As set forth
below, CS 1 provided numerous specific examples of such practices,
many of which directly involved Reyes, Byrd, and/or Canova.

CS 2 worked in the Recruitment Department at Brocade from 2001-
2003. The Recruitment Department was a part of the Human
Resources Department, and consisted of ten employees or less. It was
through this department that Defendants carried out much of their
scheme. According to CS 2, CS 2 reported to Vice President
Stephanie Jensen ("Jensen"), who worked directly with Canova and
Reyes regarding option grants. According to CS 2, Jensen, Canova
and Reyes had the Recruiting Department issue "offer letters" to new

1 employees which fixed the employee's option grant date and exercise
2 price at the date of the offer, not on the date they actually started
working for Brocade.

3 CS 3 worked in the Human Resources Department from 2002 through
4 2003 and was supervised by Jensen. CS 3 also worked with
5 Recruiting Supervisor Margie Lee ("Lee"). Lead Plaintiff learned
6 that Lee is represented by counsel because she was questioned by the
7 SEC in connection with Brocade's stock option grants during the
8 Class Period. According to CS 3, Jensen worked directly with Reyes.
9 CS 3 generated and delivered the paper work for new hire's option
10 grants and benefit packages. According to CS 3, it was very difficult
11 to secure new employees without granting options as this was a
12 significant issue to most recruits. Brocade thus gave out options to
13 new recruits with a grant date and exercise price set not by the date
they actually began working at Brocade but, instead, by the date they
were hired. Additionally, according to CS 3, if a recruit was required
to give notice or work for a prolonged period of time for his old
employer, Brocade would bring in the recruit to fill out employment
paperwork and give the recruit a false "start date" as of the date the
paperwork was filled out, and then place the recruit on a "leave of
absence" while he or she completed their prior employment.
According to CS 3, Brocade's sole purpose in doing this was to get
the recruit options at the lowest price and earliest date possible.

14 CS 4 worked in recruiting at Brocade from 2002 through 2005. CS 4
15 worked directly with Jensen who worked directly with Reyes.
16 According to CS 4, CS 4 was trained to entice new recruits to come to
17 work at Brocade by "pitching" to them that they could get early start
18 dates so that they could get lower option exercise prices. CS 4 was
19 told by CS 4's supervisors that Brocade had done this since at least as
20 early as 2000 due to the rapidly increasing stock price. CS 4 stated
21 that the Company would bring the recruit in to sign paperwork so the
22 recruit could get an official start date, even though, on average,
23 recruits would not begin work at Brocade for up to four weeks from
24 the date they were hired. The "Board" would then have an *ad hoc*
25 meeting immediately after the recruit filled out the paperwork to grant
26 options, even though the recruit had not yet started work at Brocade.
27 According to CS 4, the "Board" always was actually either: (1) Reyes
28 and Jensen or (2) Reyes and Canova.

29 CS 5 worked in the Human Resources Department in 2001.
30 According to CS 5, who worked directly with Canova and Chief
31 Information Officer James Cates, Reyes was personally aware of and
32 directly involved in the option grants to all new hires.

33 CS 9 was an executive at Brocade from 2000 through 2004, who
34 worked directly with Reyes, Byrd and then Canova. According to CS
35 9, each of these Defendants was directly involved in the decision
36 making process of deciding the timing and terms of options grants for
37 CS 9 and the employees working under CS 9's supervision.

1 41. Additionally, Brocade rewarded new hires and existing employees with significant
2 monetary loans, which were secured with nothing more than the employee's unexercised options as
3 collateral. Under these loan agreements, the Company would loan money to an employee, and the
4 employee would in return agree to exercise or cash in his or her options when the loan came due.
5 However, the loan agreements also required the employee to pay the loan in full, pursuant to an
6 acceleration clause, if the employee quit working for Brocade or was terminated by the Company.
7 This method of loaning money to employees was particularly risky to the Company because if an
8 employee quit or was terminated before his or her options had fully vested, he or she could not
9 actually exercise the options. Further, if the options were not "in the money" when the acceleration
10 clause kicked in, the options used as collateral would be worthless. As such, the Company and the
11 employees who received these loans had a tremendous, and unusual incentive, to manipulate the
12 process of granting options to recipients of loans such that the grant date would be as early as
13 possible and the exercise price would be as low as possible, in order to: (1) make the options vest
14 earlier and (2) increase the likelihood that any such options would be "in the money" in the event
15 the acceleration clause ever kicked in. Brocade never told the public that these loans were secured
16 by such option grants and that, as such, if the options used as collateral were not vested or were not
17 "in the money," the Company would be without any real recourse.

18 42. Knowing that the granting of options can severely misrepresent earnings if not
19 properly accounted for, Brocade and the Officer Defendants ignored and blatantly violated the
20 express requirements of Brocade's own Stock Option Plans and proceeded to give themselves and
21 many employees an unprecedented percentage of the company in stock options. Shareholders were
22 blissfully ignorant of the true costs that these stock option grants were wreaking on the Company
23 because Defendants omitted the material truth about what the Company was doing from all of its
24 Financial Statements issued during the Class Period.

25 43. To make matters worse, those who were charged with ensuring that Brocade was
26 reporting its financial results fairly and accurately—the Company's external auditors, and internal
27 Audit Committee—recklessly abdicated their responsibilities to the investing public by turning a
28 blind eye to what was there, just beneath the surface, if they had only chosen to look. The fraud

1 orchestrated by Brocade and the Officer Defendants would ultimately spark criminal and regulatory
2 investigations, inflict millions of dollars of losses on its unsuspecting investors, cause the ouster of
3 its then-CEO, and result in the financial restatement of every single year of its existence as a public
4 company.

5 **B. Brocade's Audit Committee's Review, Findings and Restatement**

6 44. Unfortunately for Lead Plaintiff and Brocade's other investors, Defendants'
7 misconduct would come back to haunt them when, on January 6, 2005, the Company announced
8 that it would restate its Financial Statements for fiscal years ending 2002 and 2003 to record
9 additional stock-based compensation expenses as a result of an Audit Committee internal review
10 that was later completed on January 24, 2005. During the course of the internal review, the
11 Company's own investigation determined that the way in which Brocade accounted for stock option
12 grants in publicly filed statements during the Class Period was incorrect and required restatement.
13 While it was a step in the right direction, Brocade would later admit that its improper accounting of
14 stock option grants spanned a much broader time period and was much more severe than originally
15 disclosed.

16 45. As a result of this investigation and audit, Brocade restated its Financial Statements
17 for 2001 through 2004. See Brocade Form 10-K filed January 31, 2005. On November 14, 2005, in
18 its amended SEC Form 10-K filed for the fiscal year-ended 2004, Brocade further admitted that its
19 accounting practices had failed in three major regards and, thus, that all of the Financial Statements
20 issued since its inception as a public company were materially false and misleading:

21 In January 2005, following an internal review by our Audit
22 Committee, we determined that we had not correctly accounted for:
23 (A) stock option grants that were made to new hires on their offer
24 acceptance date, rather than the date of their commencement of
25 employment, during the period May 1999 to July 2000; (B) stock
26 option grants that were made to persons engaged on a part-time basis
27 prior to their new hire full-time employment during the period August
28 2000 to October 2002; and (C) stock option grants where there was
insufficient basis to rely on our internal process and related
documentation to support recorded measurement dates used to
account for certain stock options granted prior to August 2003. As a
result, we restated our financial statements to record additional stock-
based compensation charges relating to many stock option grants
from the periods 1999 through the third quarter of fiscal 2003 as well
as a valuation allowance associated with deferred tax assets related to

1 previously recorded stock option tax benefits (the “January 2005
2 Restatement”). In addition, it was concluded that there were
3 improprieties in connection with the documentation of stock option
4 grants and related employment records of a small number of
5 employees prior to mid-2002, which resulted in immaterial
6 adjustments included in this restatement.

7 *See also* Brocade Form 10-K filed January 31, 2005, p. 56 n.3.

8 46. The Restatement was the result of an investigation conducted by Brocade’s own
9 Audit Committee. Although the Audit Committee signed off on every single Financial Statement at
10 issue, and KPMG had been paid handsomely to audit and sign off on the Financial Statements for
11 fiscal years 2002-2004, KPMG and Brocade’s Audit Committee found that the Company, under the
12 direction of Defendant Reyes, as CEO and Chairman of the Board, and Byrd and Canova as CFO,
13 had materially misled investors for virtually the entire existence of the Company. Moreover, as a
14 direct result of the Audit Committee’s findings, Brocade relieved Defendant Reyes from his
15 positions as CEO and Chairman.

16 47. Brocade further admitted that its internal controls and disclosure procedures
17 regarding Brocade’s stock option granting process were not only flawed during the Class Period but
18 were, for the most part, **utterly non-existent**. *Id.* at pp. 83-84, Item 9A. Brocade admitted that its
19 current Chief Executive Officer (Michael Klayko) and Defendant Canova concluded that “there
20 existed material weaknesses in our disclosure controls and procedures in fiscal year 2003 and prior
21 years.” *Id.* Brocade further admitted that these control inadequacies were not remedied until the
22 fourth quarter of Brocade’s fiscal year 2003 and that Brocade’s disclosure procedures and controls
23 regarding the granting of stock options were not operating effectively until October 30, 2004. *Id.*
24 Brocade further announced that significant changes were made to its Disclosure Controls and
25 Internal Controls over Financial Reporting and the stock option grant process, which were not in
26 place during all or part of the Class Period. *Id.* According to the express language of the
27 Restatement, these changes include:

28 Changes from December 2002 through October 30, 2004

1. Improvements in Disclosure Controls and Internal Controls over Financial Reporting:

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- Brocade has improved the documentation of its significant accounting policies, which are reviewed with Brocade’s Audit Committee and Brocade’s independent auditors.
- Improvements have been made to the Audit Committee charter and committee functions. The Audit Committee charter was expanded to include in its scope the responsibility to review and approve all new or changes to, significant accounting policies and positions. In addition, Brocade has expanded both the number of Audit Committee meetings from four to eight standing meetings, and the duration of those meetings. This allows a more in-depth review of complex accounting issues.
- Brocade periodically meets with its independent auditors to review all significant business issues and associated accounting implications, and any new or changed accounting policies.

2. Improvements in Internal Controls over the stock option grant process:

- Brocade has implemented cross functional teams composed of members of Brocade’s legal, accounting and human resources departments to develop improvements in the stock option granting process.
- Brocade made personnel changes in areas associated with the stock option granting process to increase the levels of experience of the personnel involved.
- Brocade formalized guidelines relating to the size and vesting schedule of stock option grants for all new employee and on-going employee grants.
- Brocade improved the documentation of the actions of the Compensation Committee and Subcommittee regarding stock option granting.
- Brocade increased the frequency of stock option grants, moving to grants on a two to three week routine cycle, and significantly reduced the processing time between grant dates and the delivery of option paperwork to employees.

Changes Subsequent to October 30, 2004

Brocade continues to implement remedial measures in response to the specific accounting and reporting issues identified by the Audit Committee internal review. These remedial measures include personnel and procedural changes to improve the controls over the financial reporting and the stock option granting process. Subsequent to October 30, 2004, the Company has implemented the following additional internal control improvements over its stock option granting process:

- Increased the Compensation Committee of the Board of Directors from one independent member to three independent members.

- 1 • The Compensation Committee refined and limited delegation of authority to a
2 Subcommittee to grant stock options.
- 3 • Documented into a formal written policy its stock option granting process.
- 4 • Created a fixed schedule for new hire grants and recurring non-executive grants on
5 the same day of each month.
- 6 • Adopted a policy of not granting executive officers options when trading is restricted
7 for executives under the Company's Insider Trading Policy.

8 48. Brocade's admissions regarding the changes to its internal controls processes and
9 disclosures for stock option grants is a shocking admission that these controls processes and
10 disclosures were **not** present during the Class Period, which, as described more fully herein, not
11 only violated its own Stock Option Plans, but also directly led to the Company's false accounting
12 for and disclosure of stock option grants throughout the Class Period. These admissions constitute
13 additional evidence of Defendants' deliberate recklessness, and, more specifically, that the Audit
14 Committee Defendants and KPMG acted with actual knowledge of these accounting violations or
15 were at the very least deliberately reckless. Indeed, these admissions in the Restatement
16 demonstrate that Brocade's Audit Committee and KPMG either knew that the Company, Reyes,
17 Byrd and Canova overtly violated the Company's Non-Statutory Stock Option Plan, or that KPMG
18 and the Audit Committee deliberately stood by and did absolutely nothing.

19 **C. The Impact of This Scheme Upon Brocade's Investors**

20 49. By using this scheme, Brocade was able to hide the true cost of these stock option
21 grants from investors. Consequently, the Company's publicly filed Financial Statements did not
22 accurately report the Company's true earnings per share, compensation expenses, related tax
23 expenses, and net income. The Restatement reduced Brocade's previously reported income by
24 approximately \$304 million in 1999-2000, and increased its non-cash compensation expenses by
25 \$52 million for 2001-2004. Brocade's reported earnings per share also were reduced as follows: in
26 2001, a reduction of \$0.05 - \$0.11 per share; in 2002, a reduction of \$0.08 - \$0.09 per share; in
27 2003, a reduction of \$0.00 - \$0.01 per share; and in 2004, the Restatement resulted in a reduction of
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1 \$0.00 - \$0.01 per share. The Restatement also had a devastating impact on Brocade's stock price,
2 causing a drop of 46 percent.

3 **D. The Governmental Investigations Against Brocade**

4 **1. The SEC and DOJ investigations**

5 50. On or about May 16, 2005, Brocade announced that the SEC began investigating
6 Brocade's accounting and disclosure of stock option grants. Brocade also acknowledged that same
7 day that the Department of Justice ("DOJ") was working with the SEC in a joint investigation
8 regarding these issues. Brocade announced on or about June 1, 2005, that the SEC had upgraded its
9 investigation into a formal investigation.

10 **2. Brocade's announcement of settlement talks with SEC during Brocade's**
11 **February 17, 2006 conference call with analysts**

12 51. Brocade publicly commented on the status of the SEC's formal investigation into the
13 accounting violations that precipitated Brocade's Restatement during Brocade's Analyst Conference
14 Call on February 17, 2006. During that call, acting CEO and President, Michael Klayko, informed
15 analysts that:

16 During the [first] quarter [of 2006], we began active settlement
17 discussions with the staff of the SEC regarding the Company's
18 restatements related to stock option accounting. As a result of
19 these discussions, in Q1 [2006] we booked a \$5 million provision
for an estimated settlement expense. This settlement amount is our
best estimate at the time and is subject to change as our discussions
with the staff of the SEC continue. (emphasis added).

20 **E. Brocade's Pending Settlement With the SEC**

21 52. Brocade filed its Form 10-Q for the First Quarter of 2006 on or about March 8, 2006.
22 In this filing, Brocade admitted that the \$5 million it had previously reserved for settlement of the
23 SEC's charges against the Company, as announced during the February 17, 2006 Conference Call,
24 was not sufficient. Therefore, Brocade announced that it had reserved an additional \$2 million, for
25 a total of \$7 million, for a settlement with the SEC and had, in fact, reached an agreement to settle
26 the SEC's claims against the Company, pending final approval by the SEC. The details of the
27 Company's announcement as stated in this 10-Q are as follows:

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1 Internal review and SEC investigation costs.

2 On January 24, 2005, we announced that our Audit Committee
3 completed an internal review regarding historical stock option
4 granting practices. Following the January 2005 Audit Committee
5 internal review, on May 16, 2005, we announced that additional
6 information had come to our attention that indicated that certain
7 guidelines regarding stock option granting practices were not
8 followed and our Audit Committee had commenced an internal
9 review of our stock option accounting focusing on leaves of absence
10 and transition and advisory roles. Our Audit Committee review was
11 completed in November 2005. In addition, we are undergoing an SEC
12 and Department of Justice (“DOJ”) joint investigation regarding our
13 historical stock option granting practices. As a result, for the three
14 months ended January 28, 2006, and January 29, 2005 we recorded
15 \$4.0 million and \$3.7 million, respectively for professional service
16 fees related to the completed internal reviews and ongoing SEC
17 investigation.

11 Provision for SEC settlement.

12 During the three months ended January 28, 2006 we began active
13 settlement discussions with the Staff of the SEC’s Division of
14 Enforcement (the “Staff”) regarding our financial restatements related
15 to stock option accounting. As a result of these discussions, for the
16 three months ended January 28, 2006 we recorded a \$7.0 million
17 provision for an estimated settlement expense. **This is an increase of**
18 **\$2.0 million over the \$5.0 million previously disclosed on**
19 **February 16, 2006 as a result of further discussions with the Staff.**
20 **The \$7.0 million estimated settlement expense is based on an offer**
21 **of settlement that the Company made to the Staff and for which**
22 **the Staff intends on recommending to the SEC’s Commissioners.**
23 The offer of settlement is contingent upon final approval by the SEC’s
24 Commissioners. (emphasis added).

19 53. The FBI’s investigation is ongoing.

20 **F. Defendant Reyes Admits that Brocade’s Board Gave Him “Sweeping Power” to Grant**
21 **Stock Options and Found “Overwhelming and Conclusive Evidence” against Him**

22 54. In an article entitled “Brocade Stung by Stock Options,” Peter Burroughs, *Business*
23 *Week*, February 13, 2006, the author reported that Reyes admitted that it would have been within his
24 powers to approve the option grants at issue in Brocade’s Restatement because Brocade’s Board of
25 Directors gave him “sweeping powers” to give out options beginning in 1999. According to the
26 author, Reyes stated that Defendant Sonsini, a member of Brocade’s Board of Directors during
27 much of the Class Period and an advisor to the Company since before it went public, urged the
28 Board to make Reyes a “committee of one” for granting options. The author also wrote that, while

1 Reyes denied wrongdoing, Reyes stated that Sonsini convinced him to resign as CEO because,
2 according to Sonsini, the evidence against Reyes was “overwhelming and conclusive.”

3 55. Thus, Defendant Reyes admitted that he was directly involved in the granting of non-
4 statutory stock options under the Company’s Stock Option Plans, which were the subject of
5 Brocade’s Restatement, and that Brocade’s own Board determined, as a result of its internal Audit
6 Committee investigation, that Reyes was involved in and at fault for this conduct. These comments
7 also establish that, according to Reyes, he was informed by Defendant Sonsini, that the evidence
8 regarding Reyes’ involvement in the accounting violations is overwhelming and conclusive.
9 Further, Reyes’ comments show that both Defendant Reyes and Defendant Sonsini acted in
10 knowing violation of the provisions of the Company’s Stock Option Plan by giving Reyes’
11 unfettered discretion to distribute options as a “committee of one.”

12 **V. BROCADE ADMITS THAT ITS FINANCIAL STATEMENTS FOR FISCAL YEARS**
13 **2000-2004 WERE MATERIALLY FALSE AND MISLEADING**

14 56. Brocade has publicly admitted that each of the Financial Statements issued during
15 the Class Period were materially false and misleading because they omitted material facts when
16 made. The specific Financial Statements at issue are all of Brocade’s SEC Form 10-K’s and 10-Q’s
17 filed for fiscal years 2000-2004, as well as numerous press releases issued by the Company during
18 these years, which incorporated the same financial information set forth therein. Due to the length
19 of these Financial Statements, the relevant portions are set forth in detail in Section VIII, *infra*.

20 57. On January 6, 2005, Brocade began to reveal that its accounting for and inaccurate
21 disclosure of stock option grants throughout the Class Period caused all of Brocade’s publicly filed
22 Financial Statements and numerous press releases issued for fiscal years 2000 through 2004 to be
23 materially false and misleading and omit material facts when made. The corrective statements,
24 ending with the filing of Brocade’s Restated Financial Statements in its SEC Form 10-K for fiscal
25 year 2004, demonstrate that these statements were materially false and misleading because they
26 omitted material facts concerning the Company’s option granting practices. Further, the
27 Restatement itself concedes that throughout the Class Period, Brocade lacked any internal controls,
28 processes and procedures regarding the accounting for and disclosure of stock option grants or, to

1 the extent any such controls, processes and procedures did actually exist, they were deliberately
2 recklessly inadequate.

3 58. On January 6, 2005, the Company issued a press release entitled "Brocade
4 Communications to Restate Financial Statements; Company Currently Expects Adjustments to
5 Relate to Stock Compensation; Company Plans to Delay the Filing of its Form 10-K for Fiscal Year
6 Ending October 30, 2004." The press release stated in part:

7 Brocade Communications Systems, Inc., the world's leading provider
8 of infrastructure solutions for Storage Area Networks (SANs),
9 announced today that it currently expects to restate its financial
10 statements for fiscal years ending 2002 and 2003 to record additional
11 stock-based compensation expense as a result of an internal review.
12 During the course of the review, which is still ongoing, the Company
13 determined that the way in which it accounted for stock option grants
14 was incorrect and requires restatement. The Company currently
15 expects the restatement to relate to stock compensation. The
16 Company does not currently anticipate any material adjustments to its
17 historical revenues, non-stock option related operating expenses or
18 cash positions. The Company expects related adjustments will be
19 made to the Company's financial statements for fiscal years prior to
20 2002, as necessary. Specifically, the Company has determined it
21 incorrectly accounted for, and will record historical stock-based
22 compensation charges relating to, (i) grants that were made to new
23 hires on their offer acceptance date, rather than the date of their
24 commencement of employment, during the period May 1999 to July
25 2000, and (ii) grants that were made to persons engaged on a part-
26 time basis prior to their new hire full-time employment during the
27 period August 2000 to October 2002.

18 Brocade's audit committee is conducting the internal review with the
19 assistance of outside counsel and accountants, both of whom were
20 retained for this purpose. The review is ongoing. There can be no
21 assurance that additional adjustments will not be required. The Audit
22 Committee expects to complete the review process in the next few
23 weeks. The Company intends to provide more information as soon as
24 it is available.

22 "Our core business remains strong and the restatement does not affect
23 the underlying fundamentals of our business. We continue to
24 successfully execute on our strategies and plans and to further
25 strengthen the overall position of the Company, " said Greg Reyes,
26 Brocade Chairman and Chief Executive Officer.

25 59. On January 24, 2005, the Company issued a press release entitled "Brocade
26 Announces the Completion of Audit Committee Internal Review; All Adjustments Are Non Cash
27 and Relate to Stock-Based Compensation and Associated Tax Adjustments." The press release
28 stated in part:

1 Brocade Communications Systems, Inc., the world's leading provider
2 of infrastructure solutions for Storage Area Networks (SANs),
3 announced today that its Audit Committee has completed its
4 previously announced internal review. As a result of the findings of
5 the review, the Company expects to record additional stock-based
6 compensation charges, which are non-cash. In addition the Company
7 expects to record a valuation allowance associated with deferred tax
8 assets related to previously recorded stock option tax benefits.

9 The Company affirmed that none of the adjustments impact historical
10 revenues, cash positions, or non-stock option related operating
11 expenses. The Company emphasized that its core business remains
12 strong and the financial restatement does not affect the underlying
13 fundamentals of the business. Brocade is working to prepare revised
14 financial statements to reflect the net stock compensation expenses
15 and associated income tax effect. Brocade will provide more
16 information as soon as it is available.

17 The table below reflects the Company's expectations of the
18 approximate impact to the Company's Pre-tax Income (Loss) and Net
19 Income (Loss):

(Amounts in Millions (1))	FY02 (1)	FY03 (1)	FY04 (1)
Pre tax income (loss) as reported	\$84	\$(134)	\$(16)
Adjustments to pre tax income (loss):			
Stock based compensation	47	(1)	(2)
Adjusted pre tax income (loss)	\$131	\$(135)	\$(18)
Income tax provision (benefit) as reported	24	2	(14)
Adjustment to tax provision (benefit):			
Changes in effective tax rate	(19)	10	28
Adjusted tax provision (benefit)	\$5	\$12	\$14
Net income (loss) as restated	\$126	\$(147)	\$(32)
Net income (loss) as reported	\$60	\$(136)	\$(2)
Change in reported net income	\$66	\$(11)	\$(30)

20 (1) The amounts provided are estimates and subject to audit. The
21 Company has not yet filed its Form 10-K report for the Year Ended
22 October 30, 2004, and there can be no assurance that these amounts
23 may not change.

1 As announced on January 6, the Company determined it incorrectly
2 accounted for, and would record historical stock-based compensation
3 charges relating to, (i) grants that were made to new hires on their
4 offer acceptance date, rather than the date of their commencement of
5 employment, during the period May 1999 to July 2000, and (ii) grants
6 that were made to persons engaged on a part-time basis prior to their
7 new hire full-time employment during the period August 2000 to
8 October 2002.

9 Upon completion of the internal review, the Audit Committee further
10 determined that there was insufficient basis to rely on the Company's
11 process and related documentation to support recorded measurement
12 dates used to account for certain stock options granted prior to August
13 2003. As a result, the Company will record additional stock-based
14 compensation charges relating to many of its stock option grants from
15 the periods 1999 through the third quarter of fiscal 2003. In addition, it
16 was concluded that there were improprieties in connection with the
17 documentation of stock option grants and related employment records
18 of a small number of employees prior to mid 2002, which resulted in
19 immaterial adjustments included in this restatement.

20 These charges will affect the previously filed financial statements for
21 fiscal years 2002 and 2003. The Company also expects to make stock
22 based compensation and associated income tax adjustments to
23 previously reported fiscal year 2004 financial results. These
24 adjustments relate solely to matters pertaining to stock options
25 granted prior to August 2003. For years prior to 2002, the Company
26 will reduce previously reported net income by approximately \$304
27 million (consisting of a reduction to net income in years 1999 and
28 2000 of \$15 million and \$1,019 million, respectively, and an increase
to net income in 2001 of \$730 million) relating solely to stock based
compensation and associated income tax adjustments. The Company
will calculate the additional historical stock based compensation
charges using the variable method of accounting under APB 25. The
stock compensation and related tax adjustments are all non-cash.

As a result of the stock compensation adjustments, the Company's
deferred tax assets previously recognized have now been fully
reserved. The Company expects to realize a tax benefit in future
reporting periods when it is able to utilize its Net Operating Losses to
offset future Income. This will result in a lower future effective
income tax rate than previously expected.

Brocade also announced today that Michael Klayko, previously Vice
President of Worldwide Sales, has been named Chief Executive
Officer, and that David House, who previously served as lead outside
director of the Company, has been named Executive Chairman of
Brocade, effective immediately. Greg Reyes, who served in these
positions for six years, will remain active as an employee advisor to
Brocade. For more information, please see the press release entitled,
"Brocade Announces Executive Appointments" issued today.

1 Brocade does not expect these developments to impact the timing of
2 its release of financial results for the first quarter fiscal year 2005,
ending January 29, 2005, expected to occur on February 16, 2005.

3 60. On April 28, 2005, Merrill Lynch cut its rating on shares of Brocade to “sell” from
4 “buy.” Shelby Seyrafi, an analyst for Merrill Lynch, stated in a research note to clients:

5 We expect Brocade to miss consensus earnings expectations for the
6 April quarter by about 2 cents per share (or 20 percent)...this could
7 cause further downward pressure on the stock, even at currently
depressed levels.

8 61. Seyrafi also stated that investors could become increasingly concerned about the
9 dilutive impact on earnings of expensing employee stock options over the next few months, leading
10 shares to “behave weakly.”

11 62. On May 16, 2005, the Company filed an 8-K that revealed that the Financial
12 Statements in question did not accurately portray Brocade’s financial results for the relevant period
13 and, therefore, should not be relied upon. Specifically, the 8-K stated as follows:

14 On May 11, 2005, on management’s recommendation, Brocade
15 Communications Systems, Inc., in consultation with KPMG LLP, the
16 Company’s independent registered accounting firm, **determined that**
the Company’s financial statements for the fiscal years ending
2001, 2002, 2003 and 2004, and the interim periods contained
therein, should no longer be relied upon because of an error in such
17 financial statements as addressed in Accounting Principles Board
18 Opinion No. 20. The Company will restate its financial statements for
those periods and expects related adjustments will be made to the
19 Company’s financial information for fiscal 2001, as
necessary.(emphasis added).

20 On that same day, Brocade issued a press release (expressly incorporated into its May 16,
21 2005 8-K) that further expounded on the Restatement:

22 **...the Company will restate its financial statements for the fiscal**
years ending 2002 through 2004 to record additional charges for
stock-based compensation expense...Following the completion of
23 an Audit Committee review announced on January 24, 2005,
24 additional information came to the Company’s attention that indicated
that its guidelines regarding stock option granting practices were
not followed during the period from August 2003 through
November 2004. After further review, the Company concluded that it
25 could not rely on the documentation used to support the recorded
26 measurement dates for stock options granted in that period. As a
27 result, the Company will restate its financial statements to account for
additional stock-based compensation for stock options granted from
28 August 2003 through November 2004. The additional charges are

1 expected to result in a cumulative increase in non-cash stock option
2 compensation expense of \$0.8 million over fiscal years 2003 and
3 2004.

4 After discovering the additional information regarding non-
5 compliance of its guidelines, the Company commenced a review of
6 certain other practices that could impact stock option accounting.
7 **This review determined that from 2001 through 2004, the**
8 **Company had not appropriately accounted for the cost of stock**
9 **based compensation for certain employees** on leaves of absences
10 (LOA) and in transition roles prior to ceasing employment with
11 Brocade...After discovering the additional information regarding
12 non-compliance of its guidelines, the Company commenced a review
13 of certain other practices that could impact stock option accounting.
14 This review determined that from 2001 through 2004, the Company
15 had not appropriately accounted for the cost of stock based
16 compensation for certain employees...Management estimates the total
17 increase in non-cash compensation expense related to these matters to
18 be in a range of approximately \$31 to \$52 million for fiscal years
19 2001 through 2004.

20 The table below reflects the total effects of these combined
21 adjustments and are the Company's preliminary estimate of the
22 approximate impact to the Company's non-cash expenses and EPS.
23 The Company does not currently expect that there will be any impact
24 on non-cash expenses and EPS for any period in fiscal year 2005.

15 year	additional non-cash expense	reduction in EPS
16 2001	\$12.0 - \$26.0 million	\$0.05 - \$0.11
17 2002	\$19.0 - \$23.0 million	\$0.08 - \$0.09
18 2003	\$0.2 - \$0.8 million	\$0.00 - \$0.01
19 2004	\$0.8 - \$2.8 million	\$0.00 - \$0.01

20 63. On November 14, 2005, the Company filed an 8-K containing a **further** restatement:

21 As previously disclosed on Form 8-K filed with the Securities and
22 Exchange Commission on May 16, 2005, Brocade Communications
23 Systems, Inc. (the "Company") determined that the Company's
24 financial statements for the fiscal years ended October 30, 2004,
25 October 25, 2003, and October 26, 2002, and the interim periods
26 contained therein, should no longer be relied upon because of errors
27 in such financial statements. The Company has restated those
28 financial statements, which appear in the Company's Annual Report
on Form 10-K/A for the fiscal year ended October 30, 2004 (the
"Form 10-K/A"). As a result of such restatements, on November 10,
2005, the Company, on management's recommendation and in
consultation with the Company's Audit Committee and KPMG, LLP,
the Company's independent registered public accounting firm,
concluded that the financial statements for the first fiscal quarter of
2005 ended January 29, 2005, should no longer be relied upon

1 because of an error in such financial statements.

2

3 Specifically, the Company concluded that the Company's balance
4 sheet for the first quarter of fiscal 2005 ended January 29, 2005 needs
5 to be restated to reflect the cumulative effect of the restatements
6 previously announced on additional paid-in capital and retained
7 earnings. The restatement of the financial statements for the quarter
8 ended January 29, 2005 relates exclusively to reclassifications within
9 shareholders equity related to the cumulative effect of the foregoing
10 restatements.

11 64. The Restatement serves as an express admission by Defendants that Brocade's
12 previously issued financial results and its public statements regarding those results were false and
13 misleading for the entire Class Period because, due to Brocade's improper accounting for its stock-
14 based compensation expenses, Brocade's Financial Statements failed to disclose material facts
15 necessary to make such statements not materially false and misleading and in violation of GAAP.

16 65. GAAP are those principles recognized by the accounting profession as the
17 conventions, rules and procedures necessary to define accepted accounting practices at a particular
18 time. Regulation S-X, 17 C.F.R. §210A-01(a)(I), states that financial statements filed with the SEC
19 that are not prepared in compliance with GAAP are presumed to be misleading and inaccurate.
20 Regulation S-X requires that interim financial statements must also comply with GAAP, with the
21 exception that interim financial statements need not include disclosures that would be duplicative of
22 disclosures accompanying annual financial statements. Brocade's Restatement of earnings was
23 clearly material. The decision as to whether to expense the grant of stock options to employees
24 directly affects a company's earnings per share. Or, better put, what outside shareholders share of
25 earnings are.

26 66. Furthermore, pursuant to GAAP, as set forth in Accounting Principles Board
27 Opinion ("APB") No. 20, the type of Restatement and revisions announced by Brocade were to
28 correct for material errors in previously issued Financial Statements. APB No. 20, ¶¶ 7-13.
Specifically, Brocade's Restatement was not due to a change in reporting entity or a change in
accounting principle, but rather to correct material errors in previously issued Financial Statements:
in particular, improper accounting regarding its stock-based compensation program that, when

1 corrected, dramatically lowered Brocade's previously stated earnings and net income, and increased
2 its compensation expenses and related tax expenses.

3 67. Further evidence of the materiality of the Restatement is the fact that there was a
4 restatement at all. GAAP notes that the restatement of past financial statements is a disfavored
5 method of recognizing an accounting change as it dilutes confidence by investors in the financial
6 statements, it makes it difficult to compare financial statements and it is often difficult, if not
7 impossible, to generate the numbers when restatement occurs. APB No. 20, ¶ 14. Moreover,
8 immaterial corrections are not required to be restated. APB No. 20, ¶ 38.

9 68. Thus, GAAP provides that financial statements should only be restated under limited
10 circumstances, *i.e.*, when there is a change in the reporting entity, there is a change in accounting
11 principles used or to correct an error in previously issued financial statements. Brocade's
12 Restatement was not due to a change in reporting entity or a change in accounting principle, but
13 rather to material errors in previously issued Financial Statements. The Restatement is, therefore,
14 material as the applicable federal securities law defines that term.

15 69. As a result of these materially false and misleading statements and failures to
16 disclose, Brocade's publicly traded securities traded at inflated prices during the Class Period.
17 APERS and other members of the Class purchased or otherwise acquired Brocade's publicly traded
18 securities relying upon the integrity of the market price of such securities and market information
19 relating to Brocade, and have been damaged thereby.

20 70. Further, as stated in its January 24, 2005 press release, Brocade was required to
21 restate its earnings because of fundamental problems with its stock compensation plan and an utter
22 lack of internal controls:

23 Upon completion of the internal review, the Audit Committee further
24 determined that there was insufficient basis to rely on the Company's
25 process and related documentation to support recorded measurement
26 dates used to account for certain stock options granted prior to August
27 2003. As a result, the Company will record additional stock-based
28 compensation charges relating to many of its stock option grants from
the periods 1999 through the third quarter of fiscal 2003. In addition, it
was concluded that there were improprieties in connection with the
documentation of stock option grants and related employment records
of a small number of employees prior to mid 2002, which resulted in
immaterial adjustments included in this restatement.

1 71. Since there was insufficient basis to rely on the Company's process and related
2 documentation to support recorded measurement dates used to account for certain stock options,
3 Brocade should have accounted for its stock-based compensation planning by using the variable
4 method under APB 25. The variable method outlined in APB 25 requires the expense to be
5 recognized in the income statement itself (with the corresponding impact to earnings per share),
6 rather than in the footnotes (with no earnings per share impact).

7 72. Brocade materially overstated its earnings despite the fact that the Company, Reyes,
8 Byrd, Canova, KPMG and the Audit Committee knew or were deliberately reckless in not knowing
9 that: (1) the Company did not have adequate internal controls in place to ensure that it was receiving
10 the documentation necessary to account for its stock-based compensation and/or (2) that the
11 Company, in fact, could not document the grant dates or vesting periods necessary to use the more
12 favorable APB 25 treatment.

13 73. Thus, the Restatement concedes that all of the Company's Financial Statements
14 issued during the Class Period were materially false and misleading because they omitted such
15 material facts.

16 **VI. DEFENDANTS WERE ACTUALLY AWARE OF AND/OR DELIBERATELY**
17 **DISREGARDED BROCADE'S IMPROPER RECOGNITION, DISCLOSURE AND**
18 **CONTROLS REGARDING GRANTS OF OPTIONS**

19 74. Each Defendant's *scienter* is readily apparent from the detailed allegations set forth
20 throughout this Complaint, all of which are adopted as if set forth in their entirety in this section.

21 75. The accounting improprieties admitted to by Brocade in the Restatement, and the
22 violations and/or lack of internal controls in the disclosure process regarding Brocade's accounting
23 of stock option grants, were the direct result of the knowing and/or deliberately reckless conduct of
24 Brocade, the Officer Defendants, the Audit Committee Defendants and KPMG. The violations
25 admitted to by Brocade involved matters and responsibilities directly charged to the Officer
26 Defendants, and the Audit Committee, and were blatantly allowed to occur by KPMG.

27 76. Defendants' Restatement itself evidences *scienter*. The Restatement concedes that
28 Defendants omitted material facts from Brocade's Financial Statements for every single fiscal year
it has been a public company. The Restatement also concedes not only that the Company lacked

1 adequate internal controls but that such controls were largely non-existent. This admission in and
2 of itself evidences that Brocade’s and the Officer Defendants’ conduct throughout the Class Period
3 violated the Company’s own written Stock Option Plans and, at the same time, evidences that the
4 Audit Committee and KPMG allowed this conduct to occur, and signed off on the Financial
5 Statements issued as a result thereof, with complete disregard for GAAP, the Company’s Stock
6 Option Plans, and the Company’s lack of adequate internal controls. Also evidencing *scienter* are
7 the Company’s \$7 million settlement with the SEC and Reyes’ statements that he was told by
8 Sonsini that Brocade’s Audit Committee fired Reyes because the evidence against him regarding his
9 role in the conduct leading to the Restatement was “overwhelming and convincing.”

10 77. Detailed allegations concerning these facts are set forth throughout this Complaint.
11 In addition to these allegations, additional evidence of these Defendants’ *scienter* is set forth below.

12 **A. Lead Plaintiff’s Confidential Sources Establish That The Officer Defendants Were**
13 **Directly Involved In And Actually Aware Of The Accounting Violations At Issue**

14 78. Lead Plaintiff has obtained information from several confidential sources who were
15 directly involved in the stock option grant process. These confidential sources, when taken in
16 isolation or viewed collectively, establish that Brocade and the Officer Defendants were aware of,
17 and indeed directly involved in, the accounting violations that formed the basis of Brocade’s
18 Restatement.

19 79. Many of the confidential sources described below worked in the Human Resources
20 Department at Brocade during all or relevant parts of the Class Period. Because of the relative
21 paucity of employees holding certain positions at the Company during this time, it would be all but
22 impossible to give the specific job title of each such confidential source, or the source’s precise
23 employment start/end dates without making the source’s true identity readily ascertainable.
24 Accordingly, in the interest of protecting the identity of these sources, the name, gender, specific
25 job title of each such source, and the exact start/stop date of each source’s employment are not
26 given. Rather, Lead Plaintiff has referred to each source by a source number (*e.g.*, “CS 1”) and has
27 set forth specific detail regarding each source’s job duties, years worked, and other corroborating
28 facts, to substantiate that each such source was in a position to know what he or she has disclosed to

1 Lead Plaintiff. Lead Plaintiff will provide the Court with a list specifically stating the name, contact
2 information, job title, and specific start/stop dates of employment for each such confidential source
3 under seal for in camera review, if the Court so requires.

4 80. **Confidential Source 1 (“CS 1”):** CS 1 was employed by Brocade in the
5 Recruiting Department from the beginning of 2000 through late 2002.

6 81. CS 1 worked with such Recruiters as Laurie DeGange, Lisa Shone and Christie
7 Louie. In 2000, CS 1 and this team reported to Maggie Bannerman (“Bannerman”), who was
8 manager of the Recruiting Department. Bannerman left in approximately April 2001. Bannerman
9 was replaced by Theresa Uchida (“Uchida”), who is the current Director of the “Global Talent
10 Group” for Brocade. During the 2000 to 2002 timeframe, Uchida reported to Vice President of
11 Human Resources (“HR”), Stephanie Jensen (“Jensen”). Greg Kayes (“Kayes”), the Manager of
12 Recruitment, also reported to Uchida. According to CS 1, Kayes and Uchida had come to work at
13 Brocade after working together at Cisco.

14 82. CS 1 stated that CS 1 was familiar with recent media reports regarding governmental
15 investigations into Brocade’s practices with regard to the pricing of employee stock option grants.
16 CS 1 then stated that during CS 1’s tenure at Brocade, the Company regularly manipulated the stock
17 option grant process in several ways, including backdating the Company’s offer letters to new
18 employee candidates, in order to provide particularly desirable job candidates with additional
19 incentives to join Brocade by using this practice to offer the benefit of probable lower strike prices
20 for option grants. CS 1 described the scheme in detail as follows.

21 83. CS 1 described three primary ways that Brocade recruited new hires, noting that each
22 method resulted in the same scheme of backdating offer letters for particularly desirable candidates.
23 The three methods were described as follows:

24 a. A job requisition was created by organization management,
25 which defined the job description. Brocade had in place
26 written guidelines dictating salary ranges and numbers of
27 shares of stock options to be granted per each category of
28 worker. This requisition request was submitted to the
Recruitment Department, which then “opens up a req” (inputs
the details into the Recruitment Department system). In many
cases, the Recruitment Department then utilized the services
of search firms (“head hunters”) – one regular vendor was

1 Heidrich & Struggles. Such firms were paid 35% of the
2 employment “package” for placement with Brocade as its
“retainer.”

3 b. In addition to the “retained” type of recruiting firm, there were
4 also contingent types of recruiting vendors, where Brocade
5 only paid a fee if a candidate brought to Brocade was actually
the candidate that was hired.

6 c. Brocade used its own recruiters to hire new candidates. This
7 method was considered to be a less expensive method and
therefore was the method Brocade used most frequently.

8 84. CS 1 stated that the HR Department also could generate proposed offers and offer
9 letters, but usually during 2000 through 2002, such was done by the Recruiters. CS 1 stated that
10 offer letters typically had the salary, number of options granted, and bonus structure that Brocade
11 would pay as compensation over a period of time. Prior to sending out the offer letter to the
12 candidate, the Recruiters circulated the proposed offer to get approval signatures from operational
13 management and above.

14 85. CS 1 stated that the Company had certain guidelines for the amount and number of
15 options that could be offered to a new hire. According to CS 1, in order to go “out of guidelines” on
16 an offer, various approvals had to be obtained. CS 1 described that normally, if the Recruitment
17 Department was negotiating a deal with a candidate, the Recruiters acted as intermediaries between
18 the prospect and organization management. It also was typically the Recruiters who made the first
19 actual agreement with prospects, asking them that if Brocade were to offer a certain amount of
20 money within a certain number of days along with benefits such as amounts of stock options, could
21 the Recruiter get a verbal commitment from the candidate. After that, an offer letter was generated.
22 CS 1 stated that this was usually the way the process worked.

23 86. However, according to CS 1, when the new hire was a candidate for a vice president,
24 manager, or an executive position, the terms for these men and women were negotiated directly by
25 Reyes, Byrd or Canova, and Jensen. Further, according to CS 1, if any offer was “out of
26 guidelines,” then additional approvals were required, and Jensen was typically the executive level
27 manager who signed off on these types of large commitments. CS 1 also described the Company’s
28 “Evergreen Plan” offered for high-level positions, which spelled out additional grants to be issued

1 annually during the person's employment. The Evergreen Plan was usually only applicable to
2 executive level personnel.

3 87. According to CS 1, Brocade's stock split three times during 2000. CS 1 noted that
4 the Recruiters and new hires believed it was highly predictable during 2000 and 2001 that the stock
5 would continue to rise in price, making the earliest date that a new-hire could be granted options
6 very important in terms of both their ultimate gain and vesting dates. That is, with the stock price
7 rising each day, and the exercise price being tied to the date of an option grant, the earlier the
8 options were granted, the lower the exercise price would be.

9 88. CS 1 described several different methods used by Brocade to back date option grants
10 and otherwise manipulate the option grant process from 2000 through 2002. Some new prospects
11 were identified through various lead sources and contacted by Recruiters. It was not uncommon for
12 managers who had worked at a previous company to recruit former co-workers, team members, and
13 executives to come aboard at Brocade. Others had connections to managers of various disciplines
14 or upper-level management, including vice presidents and executives. According to CS 1, while
15 negotiations for some upper-level management new hires were handled by the executives as
16 discussed above, once the decision was made to offer a new hire a job, the terms of any agreements
17 reached with new hires were transmitted to the Recruitment Department for purposes of generating
18 an offer letter. CS 1 stated that the offer letters were a memorialization of the employment terms
19 between Brocade and the new hire(s)— much like an employment agreement. However, CS 1
20 explained that offer letters were always generated in this manner regardless of how a prospect was
21 introduced to the Company.

22 89. CS 1 stated that Brocade's steady rise in stock price made the use of stock option
23 grants a valuable incentive to both new hires and management because the new hires could be
24 enticed into accepting an offer without the Company incurring the expense of a high salary. CS 1
25 detailed Brocade's practice of backdating offer letters for desirable prospects—most of whom were
26 generally well aware of, and compared rising stock prices among, tech companies in the Silicon
27 Valley—as a way of evaluating a move to a new employer.

28

1 90. According to CS 1, Brocade used a scheme of backdating option grants awarded to
2 new hires. As an example of the backdating practice, CS 1 indicated that an employee would first
3 be contacted by Brocade on May 1, 2000, when employment was discussed. A verbal offer would
4 be given, and a start date of May 30, 2000, agreed upon. A formal offer letter would be sent on
5 May 15, 2000. For purposes of this example, assume that Brocade's stock rose from \$180 on May
6 1 to \$230 by May 30. During 2000 and 2001, the possibility then existed for a Board meeting to
7 occur between May 1—the date a recruiter first began speaking with this employee and May 30—
8 the date the employee actually was to begin work. To further entice the employee to join Brocade,
9 the Recruiter would tell the prospect that his or her start date would be backdated on the offer letter
10 to a time before whenever the Board meeting actually occurred.

11 91. CS 1 explained that this was done in order to take advantage of the lower price on
12 the earlier date and to start the vesting process. The start date reflected on the offer letter, and even
13 sometimes the date of the letter itself, were then backdated to a date prior to a Board meeting that
14 followed those dates. This scheme gave the false appearance that the employee had joined the
15 Company prior to a date when he or she actually had started their employment and, thus, prior to the
16 time their strike prices for their options were fixed.

17 92. CS 1 also explained another method, whereby both the offer letter date and start date
18 were backdated. This method was used when a highly desirable candidate was communicating with
19 Brocade about coming onboard at some point following a Board meeting. CS 1 said that once an
20 offer was fixed, in order to close the deal, Recruiters would include in their verbal negotiations an
21 offer that the employee's formal offer and start dates would be backdated to a date before a Board
22 meeting that had *already occurred*—and at these times, the employee prospect would, therefore,
23 already know the strike price. This scenario usually occurred when Recruiters were already in
24 touch with desirable candidates, and in the process of negotiating or processing an offer letter.
25 Meanwhile, a Board meeting would occur, or was about to occur, and the prospect would be
26 contacted and given an opportunity to accept the position with Brocade if they got their options
27 priced at the Board meeting—a meeting that occurred before they had even received a formal offer
28 letter or started work. In some cases, this practice was used to recruit extremely desirable

1 candidates, who were hired well after the Board had set a strike price for employees hired in a
2 previous period.

3 93. CS 1 said that from 2000 to 2001, “Board meetings” were held *ad hoc*, and that there
4 seemed to be no regular schedule or even range of days in between such meetings. CS 1 recalled
5 that some of these *ad hoc* meetings noticeably occurred just after the stock had dipped in price. The
6 stock would begin to climb back, or would simply rebound and keep going up, and a Board meeting
7 would quickly follow. CS 1 stated that CS 1 is certain that it was “not unusual” that subsequent
8 offer letters were backdated along with start dates to take advantage of prices set at such Board
9 meetings that had already occurred during this two year timeframe.

10 94. CS 1 stated that at some point in 2002, Brocade migrated to a system of holding
11 *regular* Board meetings for option grants, usually meeting twice monthly around the fifteenth and
12 thirtieth of each month. At that time, offer letters generated before the fifteenth of the month would
13 be included in the strike price the Board issued on the fifteenth, and letters dated between the
14 fifteenth and thirtieth would be subject to the strike price decided on the thirtieth. Brocade’s
15 Recruiters were not allowed to tell prospects when the date of the next Board meeting would be but,
16 instead, encouraged them to hurry up and join Brocade so that they could get the benefit of the
17 strike price that would be awarded at the next meeting.

18 95. As described by Lead Plaintiff’s other confidential sources, this new system led to
19 the process of Brocade bringing in new hires to fill in paperwork before they actually started
20 working at Brocade so they could be classed as an employee or placed on a leave of absence, and
21 thus get options at the next Board meeting, even though the new hire still had not actually begun
22 working at Brocade and, in many cases, was still working at another company. CS 1 stated that
23 offer letters were not backdated as frequently at this point, *but that start dates still* were if an
24 employee had received an offer letter before the date of the next Board meeting, but the true start
25 date occurred afterward.

26 96. CS 1 stated that even after Brocade “tightened up” the offer letter practices by
27 holding more regular Board meetings, CS 1 observed that strike prices had been set for batches of
28 offer letters based on a market price that had occurred on a date between two Board meetings. CS 1

1 knew about this practice because Recruiters were still in touch with new hires and HR about various
2 issues pertaining to new employees until after the candidates had actually come to work and gone
3 through official orientation. Even then, there were sometimes still “loose ends” or questions raised
4 by new hires with respect to their offer letters and benefits, and so, Recruiters often became aware
5 of strike prices awarded by the Board for the grants in batches of offer letters that had been
6 generated since the previous Board meeting.

7 97. CS 1 explained that Reyes was necessarily involved in offers for high-level positions
8 because Brocade was a small company. According to CS 1, these offers represented significant
9 commitments on behalf of the Company, and Brocade was competing with larger companies to
10 recruit some of its key personnel. One way to entice these higher-level candidates was to address
11 the current stock price, but promise that they could get a lower price on their options based upon a
12 price that was awarded to others at a prior Board meeting before this candidate had been recruited.

13 98. CS 1 provided several specific examples of such offers. CS 1 recalled the approvals
14 process for an offer to Dan Cudgma (“Cudgma”), a Brocade Vice President, which was well beyond
15 Company guidelines. Offers to such high level candidates, which were “out of guidelines,” required
16 involvement from Jensen, Reyes and the CFO. CS 1 recalled there being quite a rush to get
17 approvals and the “t’s crossed and i’s dotted” so that Cudgma could take advantage of a lower strike
18 price.

19 99. Lead Plaintiff’s other Confidential Sources, including CS 4, have verified that
20 Cudgma was given a loan by Brocade in the amount of approximately \$1 million. According to CS
21 4, at some point Cudgma had a disagreement with Reyes and threatened to expose the “whole
22 backdating thing.” Cudgma was eventually terminated and, according to legal documents reviewed
23 by Lead Plaintiff, Brocade filed for foreclosure against Cudgma and foreclosed on his home. Lead
24 Plaintiff’s Confidential Sources, including CS 4, have confirmed that Cudgma is the whistleblower
25 who told the governmental regulators about Reyes’ manipulation of Brocade’s Stock Option Plans,
26 which led to the SEC and DOJ investigations against Reyes and Brocade.

27 100. CS 1 also recalled the hiring of Evan Ellis (“Ellis”), a heavily-recruited sales Vice
28 President, to whom Brocade management *guaranteed a \$5 million gain* on his initial stock option

1 grant in 2001. Ellis came to Brocade through Jack Cuthbert (“Cuthbert”), who was a Brocade Vice
2 President and spearheaded the recruiting of Ellis. Cuthbert and Ellis had worked together
3 previously at SGI, where Ellis was Cuthbert’s boss. CS 1 said that Brocade included in the writing
4 of the offer letter generated to Ellis this guarantee of a \$5 million gain without any conditions such
5 as whether the shares had even vested.

6 101. CS 1 stated that Ellis started as either a Vice President or Director of Sales. Cuthbert
7 “pushed Ellis through” the process, according to CS 1, and ultimately, the offer to Ellis was “way
8 out of guidelines.” This meant that a higher amount than Brocade’s guidelines was ultimately
9 offered, and the number of stock options was also greater than Company policy authorized. As
10 discussed above, such “out of guidelines” grants required the involvement of Jensen, Reyes and the
11 CFO.

12 102. According to CS 1, within approximately eighteen months to two years, Ellis was in
13 great conflict with management and decided to leave Brocade. The Company refused to pay Ellis
14 the \$5 million guarantee and, according to CS 1, Ellis threatened suit to enforce his deal. CS 1
15 related, from information made available to CS 1, that Reyes invited Ellis to a hotel, and met one-
16 on-one with Ellis in a room, where Reyes told Ellis that if Ellis did not back off of his lawsuit—
17 attempting to recover the \$5 million guarantee—Ellis “would never work again in California.” CS
18 1 suggested that the threats from Reyes went even deeper than Ellis’ potential future employment.
19 According to CS 1, after this meeting, the case was settled.

20 103. CS 1 also recalled that Tim Duffy (“Duffy”) was recruited with a backdated offer
21 letter to take advantage of a lower strike price for a large stock option grant. Duffy was hired
22 sometime in approximately early 2001. In addition, Duffy was paid a sign-on bonus of \$70,000—a
23 huge cash bonus by Brocade’s standards. Again, this was another “out of guidelines” deal. CS 1
24 said that Duffy, like many of Brocade’s highly desirable job candidates, was directly told that his
25 offer letter and start date would be backdated to before the time he was actually able to begin work,
26 as a recruiting tool to award him a lower strike price.

27 104. CS 1 stated that when Brocade was trying to convince CS 1 to become an employee,
28 part of the offer Brocade made to CS 1 involved backdating CS 1’s start date.

1 105. CS 1 stated that in 2000, Recruiter Christie Louie (“Louie”) was hired after having
2 been a contractor for over a month. The offer letter backdated Louie’s start date by indicating that
3 Louie had become an employee of Brocade at the time she had actually started as a contractor in
4 order to provide her a strike price that had already been established in a prior Board meeting.
5 However, after the fact, Brocade later demanded that Louie return all the money she was paid as a
6 contractor—approximately \$40,000 to \$50,000.

7 106. CS 1 also described another method used by the Company to carry out their scheme.
8 CS 1 stated that the Company, upon negotiating severance agreements, in particular with upper-
9 level managers being laid off, would allow those managers to remain technically employed for a
10 period of time so that their options either could vest or could at least potentially appreciate to a
11 higher price. CS 1 related CS 1’s review of documents showing the process of Brocade awarding
12 terminated employees leave of absence status, usually involving an employee who was terminated
13 close to his or her vesting date. However, according to CS 1, this practice was very selective as to
14 which employees were given this kind of special treatment. CS 1 related an email exchange with
15 Jensen over this very issue, with statements or acknowledgements by Jensen that certain terminated
16 employees were being categorized as “on leave of absence” in order to vest options.

17 107. CS 1 stated that Recruiters often discussed the timing of how Brocade laid off
18 employees, and then would quickly fill their positions with new hires. The layoffs often coincided
19 with dates close to vesting dates of options, where the options would not vest and the stock went
20 back to the Company. From what CS 1 understood, this gave back to the Company stock that could
21 then be offered at lower prices at times when the market price had risen since the original grant. As
22 described above, in other instances, employees were given severance packages that allowed them to
23 go on leave of absence until a date that their stock options vested. CS 1 stated that this had to do
24 with Brocade’s “playing favorites” and also avoiding disputes with the workers that caused concern.

25 108. CS 1 further described that if stock prices were going down, it was beneficial to
26 Brocade to repatriate. For example, if original options were granted to an employee at \$130 per
27 share, but the stock price had declined to \$10.00, there was usually not much dispute when
28 employees were laid off before vesting dates. However, by initiating layoffs before vesting dates,

1 Brocade would get this stock back, which, according to CS 1, made the stock pool larger. More
2 shares could then be offered at a lower price without being diluted to either one of the executives
3 being retained, or somebody new being hired.

4 109. CS 1 stated that highly sought candidates like Ellis or Duffy were typically offered a
5 backdated offer letter and a strike price that had been awarded in prior periods. CS 1 recalled that
6 this use of older strike prices from prior periods sometimes involved about a thirty-day differential,
7 but could even be a price awarded to others months earlier. CS 1 also stated that, for example, there
8 would be an actual hire date of October 1, but that the strike price would be September 2, and in
9 some cases, even months before. CS 1 is certain that lower prices from prior periods were granted
10 for highly desirable candidates hired later.

11 110. CS recalled that Regan McGrath was recruited and then relocated to Brocade in
12 California, from his residence in Canada in approximately early 2001. Included in the offer to
13 McGrath was an approximately \$1 million loan. McGrath was let go in 2003 or 2004, and the
14 Company was forced to relocate him back to Canada. As discussed above, such “out of guidelines”
15 grants required the involvement of Jensen, Reyes and the CFO.

16 111. CS 1 recalled that Steve Dehib was a senior product marketing manager heavily
17 recruited by Brocade in 2001. CS 1 handled the offer letter process with him, recalling that various
18 parts of the offer were “way out of guidelines,” including an exceptionally high number of options
19 and backdating of his offer letter and/or start date. As discussed above, such “out of guidelines”
20 grants required the involvement of Jensen, Reyes and the CFO.

21 112. CS 1 also recalled that Mark Koch was a sales executive hired by Brocade in New
22 York, with the terms of his offer being significantly out of guidelines, as well. CS recalled that
23 Koch’s offer letter was backdated in order that he could take advantage of an earlier strike price as
24 well. As discussed above, such “out of guidelines” grants required the involvement of Jensen, Reyes
25 and the CFO.

26 113. All of the methods, practices, and specific instances described by CS 1 directly relate
27 to the violations admitted by Brocade in the Restatement.
28

1 114. *Confidential Source 2* (“CS 2”): CS 2 worked at Brocade from 2001 through mid-
2 2003. CS 2 worked in the HR Department. CS 2 was responsible for the process of “on boarding”
3 Brocade’s new hires. The “on boarding” process included explaining the new hire’s employee
4 benefits, including options grants, and distributing benefit packages to each such new hire.
5 According to CS 2, Brocade’s recruiters made salary and stock option offers to new hires. The
6 Recruiting Department within the HR Department had a “Benefits Guide,” which set forth the
7 number of stock options to be given to new hires depending upon their specific job category.

8 115. CS 2 stated that the Benefits section of the HR Department was very small and
9 consisted of approximately 10 employees. CS 2 reported that CS 2 worked directly with Heidi
10 Rado, Manager of Employee Compensation and Benefits, and that Rado reported directly to Jensen,
11 Vice President of HR. According to CS 2, CS 2 attended weekly meetings with Jensen, who
12 verbally informed CS 2 that Jensen worked on the details of employee stock options with Brocade’s
13 CFO, Defendant Canova. CS 2 also stated that Jensen worked directly with Defendant Canova with
14 regard to stock options for new hires, as such was a regular topic of discussion among CS 2 and the
15 employees of the HR Department. CS 2 stated that Brocade’s Stock Plan Administrator, Elizabeth
16 Moore, was also involved in the implementation of Brocade’s benefits plans and options grants.

17 116. After management had approved the terms of a new hire’s offer and a new hire
18 accepted an offer of employment, the recruiter was required to inform the HR Recruitment
19 Department, which would then generate an “offer letter.” As part of CS 2’s regular daily job duties,
20 CS 2 received copies of “offer letters” from Brocade’s Recruiting Department. According to CS 2,
21 when CS 2 prepared each new hire’s “on boarding” package, CS 2 saw the new hire’s offer letter
22 and such offer letters routinely showed the stock option exercise price to be fixed at the time the
23 new hire accepted an offer of employment, not at the time the new hire actually received a written
24 offer or after the new hire started working at Brocade. That is, the exercise price in each such offer
25 letter was based upon the date the new hire accepted the offer, even if the offer letter itself was not
26 generated until several days later. This is one of the precise accounting violations admitted to by
27 Brocade in its Restatement. *See* Brocade’s SEC Form 10-K filed January 31, 2005.

28

1 117. *Confidential Source 3* (“CS 3”): CS 3 worked for Brocade from 2002 through
2 2003. CS 3 was employed in the HR Department and was directly involved with the recruitment of
3 new employees. CS 3 worked with three Recruiting Coordinators, and reported to Recruitment
4 Supervisor, Margie Lee.

5 118. Pursuant to Lead Plaintiff’s investigation, Lead Plaintiff has learned that Margie Lee
6 is represented by counsel as she has been interviewed by the SEC with respect to Brocade’s
7 improper accounting for stock option grants during the Class Period.

8 119. According to CS 3, Margie Lee reported to Greg Kayes, Manager of Recruitment,
9 who reported to HR Director, Uchida, who reported to Vice President of HR, Jensen. Jensen
10 reported to Defendant Reyes.

11 120. CS 3 was involved in the process of recruiting new hires. According to CS 3, each
12 day CS 3 made “cold calls” over the telephone and searched computer databases to find prospects to
13 work for Brocade. CS 3 stated that due to the extremely competitive job market in the Bay Area
14 during the early part of the Class Period, recruiters for Brocade had to be very aggressive in trying
15 to obtain new hires. CS 3 states that Brocade recruiting coordinators had access to a Brocade
16 “Benefits Guide” and database, which contained information regarding the benefits Brocade
17 offered. This database contained a “stock guide,” which set forth the range of options shares to be
18 offered based upon the starting salary and job title for which the new hire was being considered.
19 According to CS 3, most new hire candidates that CS 3 recruited were concerned about stock option
20 exercise prices.

21 121. CS 3 stated that when CS 3 contacted a qualified and interested new hire candidate,
22 an interview was set up for the new hire prospect with a member of the HR Department and a
23 management level person from the specific department or area for which the new hire was being
24 considered. If the management person decided to extend an offer to the new hire, the management
25 person instructed the Recruiting Department to generate an “offer letter.” The recruiter who was in
26 charge of contacting the new hire was required to inform the new hire that Brocade was extending a
27 job offer and to give the new hire the details of that offer, including the number of options and their
28 exercise price. According to CS 3, at this point, an offer letter itself was generated. CS 3’s job

1 duties included the preparation of such offer letters. CS 3 states that through this process, most new
2 hires were made aware of the exercise price of their options at the time they were hired, before they
3 actually began working for Brocade. This is one of the precise accounting violations admitted to by
4 Brocade in its Restatement. *See* Brocade's SEC Form 10-K filed January 31, 2005.

5 122. CS 3 also described a process whereby Brocade's management improperly used
6 "leaves of absences" to manipulate a new hire's options grant. CS 3 described a frequent scenario
7 involving employees who were not able to start working at Brocade right away (usually because
8 they needed to provide notice and continue working for their prior employer for a given period of
9 time). According to CS 3, Brocade would have such new hires come into work for a meeting
10 (ostensibly for the purpose of meeting with HR to fill out some new employee paperwork), for the
11 sole purpose of establishing a false start date.

12 123. After the meeting, those employees left immediately and then returned later, usually
13 within four weeks, to actually start working. According to CS 3, the new employees came in well
14 before they could actually begin work, in order to create an illusory "start date," so that the
15 employee and Brocade could report an earlier and more favorable exercise price (and date of grant)
16 rather than using the strike price from the date they actually commenced employment, which was
17 usually weeks later. CS 3 stated that the time lag in between the candidate coming in for the initial
18 "start date" set just for purposes of obtaining a lower strike price, and the date that the employee
19 actually did come in to begin work at Brocade, was treated by the company as a "**leave of absence.**"

20 124. This is one of the precise accounting violations admitted to by Brocade in its
21 Restatement. *See* Brocade's SEC Form 10-K filed January 31, 2005.

22 125. ***Confidential Source 4 ("CS 4")***: CS 4 worked at Brocade from 2002 through 2005
23 in the Recruiting Department. CS 4 reported to Uchida and later Kayes, each of whom reported to
24 Vice President of HR, Jensen. According to CS 4, Jensen reported directly to Defendant Reyes.

25 126. CS 4 states that the Brocade recruiters were trained to entice new job candidates to
26 work for Brocade by offering them the opportunity to report to the Company for an "early start
27 date" in order to take advantage of a potentially lower strike price on their initial option grants. CS 4
28 described that eliminating a two to four week delay between the time of hire and the time of

1 actually beginning work was potentially of substantial value to a new hire’s stock option grant
2 because of the steady increase in Brocade’s share price, specifically during the 2000-2003 time
3 period.

4 127. CS 4 described the recruitment process as follows: recruiters would both cold-call a
5 potential candidate either by seeking out those in certain positions at other companies, or finding
6 out that individuals were potentially looking for new jobs with resumes posted on databases. The
7 recruiters also responded to those who visited Brocade’s website, and who either applied or
8 expressed interest in knowing more about working for the Company. Once a recruiter contacted a
9 prospect and the person was considered a “candidate” by the recruiter, a “phone screen process”
10 was conducted, where the recruiter and often the designated manager screened a candidate through
11 additional discussions, and sometimes questionnaires.

12 128. Then, the candidate was subjected to interviews—first with a manager from the
13 appropriate discipline, then members of a cross-functional team that would be working with that
14 person, and sometimes members from the team that that person would be working with. There were
15 usually two rounds of these interviews before Brocade management decided to present an offer
16 letter. There was no definitive procedure for this, each department manager did things a little
17 differently and the recruiting department would accommodate them.

18 129. CS 4 learned upon beginning work in early 2002, that since at least 2000, Brocade’s
19 recruiters were trained to tell prospects that strike prices would be determined at the very next
20 Board meeting after their start date. Recruiters further explained that there was no regular schedule
21 for these meetings so that they could occur within one week to one quarter after the new-hire’s
22 “start date.” Due to Brocade’s rising stock price, this was a potential problem because the stock
23 price, and thus the exercise price, of any options granted to a new hire could and did rise
24 dramatically on a weekly, and often daily, basis.

25 130. Consequently, CS 4 said that CS 4’s supervisors, including, Uchida, told CS 4 how
26 to pitch “early start dates” to new hires, in order to get them lower exercise prices, and that Brocade
27 always tried to get new employees the best option price when joining the company. CS 4 states that
28 Brocade systematically brought new hires into the Company before they actually started to give

1 them a false “start date” so that the “Board” could set an award of options and fix an exercise price
2 and grant date of the options well-before the employee actually started working at Brocade, and
3 most of the time, the new employees were still actually working at other companies. CS 4 states
4 that lower strike prices were the only reason why new hires were offered to come into Brocade on
5 an agreed “early start date,” while not expected to report for actual work until a later, agreed “actual
6 start date” for orientation. On these “early start dates,” new hires met with the person who would
7 become the candidate’s manager (or at least one of them). Usually, the new hire was still required
8 to work out a notice period with their previous employer (from where they were often recruited).
9 Others had various other types of commitments that resulted in a necessary delay in reporting for
10 work before an agreed start date.

11 131. By coming into Brocade early, for just a short time on one day, Brocade created
12 “early start dates” according to CS4 so that the new hires would lock in the benefits of option strike
13 prices set at the very next Board meeting. This practice eliminated the risk of waiting for a future
14 meeting that would set the price after an actual start date. In order to secure the early start date, the
15 new-hire did not have to go through “New Hire Orientation” – that would wait until actually
16 reporting for work on a later date. However, the candidates accepting a position and appearing for
17 an early start date were required to execute a Brocade “Non-Disclosure Agreement” (NDA) for the
18 company employees. CS 4 stated that Brocade began to wind down this scheme in 2004 because
19 the stock flattened and was trending downward, thus eliminating early start dates as an incentive for
20 new hires.

21 132. CS 4 said that CS 4 and other recruiters, as well as many job candidates were
22 “uncomfortable” with the early start date practice. The form offer letters that Brocade sent to new
23 hires included two sentences that identified the employee’s early start date (this would be filled in
24 by recruitment after agreement with the candidate) and the actual date the employee would actually
25 begin work (also filled in on this form). The recruiters necessarily discussed this practice with
26 candidates in order to ascertain which dates would be filled in on the offer letter. The language
27 used in these communications described “the early start dates” practice as a regular one that was
28

1 applicable and available to most new hires, and was especially accommodating to “hot” candidates
2 (in demand and uniquely desirable to Brocade).

3 133. CS 4 also stated that from 2000 to 2002, the average time difference between the
4 false “start date” and actual start date was two to four weeks; from 2003 though 2004, the average
5 time difference was about two weeks. CS 4 described that this was also a time of great action for
6 other companies in Silicon Valley, whether established or start-up, causing talented workers to be in
7 high demand. Recruiting was so aggressive that many companies demanded extended notice for
8 people to leave and included a two-week to 30-day notice period as part of employment agreements.
9 Thus, according to CS 4, Brocade used this scheme to manipulate the process of offering option
10 grants to new hires.

11 134. According to CS 4, strike prices were set pursuant to this scheme by using *ad hoc*
12 “Board Committee Meetings” – which consisted of two people: (1) Reyes and Jensen or (2) Reyes
13 and the acting CFO (Defendant Byrd and later Defendant Canova). CS 4 states that it was widely
14 known within the recruitment department and throughout the Company that Jensen worked directly
15 for and with Reyes on stock option grants, especially when higher-level managers were the
16 grantees. CS 4 also states that CS 4’s recruitment office was near a conference room often used by
17 the executives, and CS 4 frequently saw Defendant Reyes meeting with these individuals. CS 4
18 explained that when starting out with Brocade, CS 4 quickly became familiar with Reyes’ “Board
19 meetings” that were held for option grant purposes, always after a time when Brocade’s stock price
20 had declined, bottomed, and then was starting to rise again. The meeting dates always tracked a
21 period where the stock had dipped. CS 4 personally observed that the strike prices were regularly
22 derived from the stock’s low points between these Board meeting dates, and this observation was
23 openly discussed as Defendant Reyes’ practice within the recruitment and HR departments.

24 135. CS 4 said the occurrence of these meetings also was prompted by how many offers
25 Brocade had out, whom they had offers out to, and whom Defendant Reyes “wanted to do
26 something for.” CS 4 described Defendant Reyes as having an internal reputation at the Company
27 as a narcissist, who believed Brocade was his own company, and the type of the person who truly
28 believed he was self-entitled to do whatever he wanted there.

1 136. CS 4 said that the numbers of options granted to finance and engineering types, in
2 general, were far lower than those recruited for the sales organization. CS 4 explained that
3 Defendant Reyes was a “sales-oriented CEO,” and that while Brocade was known for paying well,
4 that the stock option grants were clearly in favor of sales people. CS 4 states that recruiters in the
5 sales area, as well as upper-level managers and Vice Presidents in that area, pushed this early start
6 date process very aggressively. CS 4 said that these were the categories of employees receiving the
7 largest grants, and with salaries that were better than competitive. CS 4 explained that some
8 prospects were more interested in a higher salary and accepted a lower number of options, but
9 others – especially sales people – took lower base pay in order to get larger numbers of options. CS
10 4 states that many times, these awards were “exorbitant” and always tied to a nearly immediate
11 “early start date.”

12 137. CS 4 also stated that CS 4 recruited operations people, and workers for virtually all
13 other positions at the San Jose Headquarters. On the other hand, sales persons could work
14 anywhere in the country, according to CS 4, and not even see their manager until two to three
15 months after their actual start date. For those persons working at the San Jose Headquarters, new
16 employees went through orientation on their very first day of actual work. CS 4 explained it was
17 much easier for sales persons stationed across the country to seemingly begin work for Brocade,
18 while continuing to work out a notice period for their former employer and thus sales people
19 aggressively negotiated the soonest of early start dates.

20 138. CS 4 stated that with employees coming in to secure their “early start date,” the
21 recruiters were made aware of their arrival for a brief meeting with management. Shortly thereafter,
22 these new-hires left, not to return until the date they actually began work. CS 4 said that CS 4
23 recalled instances where the start date and actual beginning of employment with Brocade were
24 regularly two weeks to even a month apart, although some managers gave tasks to their new hires to
25 perform in the meanwhile, like reading up on Brocade materials. CS 4 states this was an exercise to
26 appease the manager’s anxiety over participating in the establishment of a sham start date.

27 139. CS 4 further stated recruiters were not always involved in new-hires. Sometimes
28 upper level management made deals with “hot candidates”—and especially for particularly high-

1 level positions like Vice President and above. In many circumstances, Vice Presidents brought
2 others with them over from another company, and job positions were created within Brocade for
3 these migrant teams. In this scenario, the recruiters became aware that “job requisitions” were
4 created for these new hires, and recruitment generated offer letters with information from upper
5 level managers or even the executives. According to CS 4, Defendant Reyes “micromanaged” this
6 process.

7 140. CS 4 states that by 2004, when Brocade’s stock had fallen below years of
8 performance, Defendant Reyes was losing a lot of key people and could not find any other ways to
9 motivate them to stay. Reyes had relied heavily on option grants to entice people away from other
10 companies, but was personally disliked for having fired virtually the entire “V&C level” (Vice
11 President and CTO, COO, etc.) in short periods.

12 141. *Confidential Source 5 (“CS 5”)*: CS 5 was employed by Brocade in the Human
13 Resources Department during 2001. CS 5’s job duties included the recruitment of new-hires. CS 5
14 worked with several departments to assist in filling requisitions for new employee hires. CS 5
15 reported to Director of HR, Uchida, who reported to Vice President of HR, Jensen. According to
16 CS 5, Jensen reported directly to Defendant Reyes. CS 5 worked directly with Defendant Canova
17 as well as Brocade’s Chief Information Officer, James Cates, regarding new-hire candidates in their
18 respective areas. CS 5 also stated that CS 5 worked on recruiting new hires for Brocade’s
19 international operations with Vice President of International Sales, James Lalonde, HR Coordinator,
20 Lee Gagnon, and Recruitment Supervisor, Margie Lee.

21 142. CS 5’s job duties included analyzing database and contact information to find
22 potential new hires who may possess the qualifications and requirements for each position sought to
23 be filled. After receiving a new hire requisition from a specific department or area, CS 5 worked
24 directly with the management person in charge of that department or area throughout the recruiting
25 and hiring process. CS 5 utilized Brocade’s internal database information regarding the ranges of
26 salary and stock option grants generally available for new hires based upon the specific job title
27 being filled. CS 5 would then bring in suitable candidates to meet with management.

28

1 143. If the management level person of the specific department decided to extend an offer
2 to the new hire, CS 5 would then prepare a requisition to approve the hiring with the required
3 information regarding options and salary ranges. According to CS 5, the new hire requisition
4 approval was required to be signed by the management person in the department for which the
5 person was being hired, a member of the finance department, and a HR Coordinator. CS 5 also
6 stated that if a new hire was being offered a job with terms that differed from the ranges of salary
7 and options for such a position as set forth in the Brocade database, then Defendant Canova was
8 required to sign the requisition. Brocade then issued an “offer letter” based upon the approved
9 requisition, which set forth the new hire’s information regarding salary and options. CS 5 stated
10 that there were repeated instances where CS 5’s management level persons, including Vice
11 President of International Sales, James Lalonde, ordered CS 5 to offer salary and options beyond
12 that set forth in the amounts approved for each specific job title in the Brocade database. CS 5
13 stated that in each instance, Lalonde informed CS 5 that Defendant Reyes was aware of and had
14 personally approved the terms of the offer.

15 144. This is one of the precise accounting violations admitted to by Brocade in its
16 Restatement. *See* Brocade’s SEC Form 10-K filed January 31, 2005.

17 145. ***Confidential Source 6 (“CS 6”)***: CS 6 was employed by Brocade as a Senior
18 Accountant from 2002 through 2004. CS 6 stated that CS 6 was recruited by the Company to work
19 in the Company’s Finance Department. CS 6 stated that CS 6 received stock option grants as part
20 of CS 6’s new hire compensation package. CS 6 also stated that CS 6 was given an exercise price
21 for CS 6’s options at the time CS 6 accepted the job offer and that such options were granted to CS
22 6 pursuant to a “Board Resolution.” CS 6 also confirmed that Elizabeth Moore was directly
23 involved with Brocade’s stock option grant program during the period of CS 6’s employment at
24 Brocade.

25 146. ***Confidential Source 7 (“CS 7”)***: CS 7 worked for Brocade as an internal Sarbanes-
26 Oxley auditor in 2004. CS 7 reported directly to Senior Accountant Jennifer Cebenoyan. CS 7
27 stated that Brocade originally hired Ernst & Young and later Deloitte & Touche, LLP to conduct the
28 external audit of Brocade, but that neither outside auditor completed its work. Instead, Brocade

1 conducted its audit internally and hired CS 7 and one other person to conduct this audit. According
2 to CS 7, the other “auditor” was not familiar with GAAP and did not have an accounting
3 background.

4 147. According to CS 7, Brocade did not have adequate procedures and controls in place
5 to conduct an internal audit. For example, CS 7 stated that the personnel auditing the controls and
6 procedures regarding option expenses did not have accounting backgrounds and were not familiar
7 with how to apply GAAP to this process. CS 7 further stated that Brocade required CS 7 to compile
8 narratives to describe Brocade’s controls and procedures without first assembling flow charts to
9 identify the points at which the internal control processes should be examined. CS 7 stated that the
10 appropriate manner to conduct such an audit is to first compile and/or examine such flow charts and
11 then prepare a narrative to explain the results. CS 7 also explained that it is appropriate to utilize
12 certain operating software to conduct such a review and prepare the resulting report. However,
13 according to CS 7, Brocade did not possess any such operating software and had no such
14 operational control flow charts. CS 7 also stated that CS 7 had significant disagreements with
15 Brocade regarding the manner in which Brocade accounted for credits and collections (specifically,
16 CS 7 instructed Brocade that such auditing work must focus on the controls regarding the first
17 opportunity for sale, but Brocade refused and instructed CS 7 to focus the audit after the point at
18 which a contract had already been executed).

19 148. CS 7 stated that CS 7 voiced these disagreements to Cebenoyan, who voiced them to
20 management and that Brocade terminated CS 7’s employment as a result.

21 149. **Confidential Source 8 (“CS 8”)**: CS 8 was employed by Brocade from early 2002
22 though the end of 2004. CS 8 held different job titles while employed in Brocade’s HR
23 Department. One of CS 8’s job duties was data entry for new hires, terminations and running
24 reports. CS 8 also became responsible for forwarding offer letters and new employee information
25 packets to new-hires.

26 150. CS 8 stated that the HR Department was divided into three parts: Recruitment,
27 Compensation and Benefits, and HR Information Systems. During CS 8’s employment at Brocade,
28 CS 8 reported to Kayes, Manager of Recruitment. Kayes reported to Uchida, Director of Global

1 Talent. Uchida reported to Jensen, Vice President of HR, until December 2003. According to CS
2 8, Jensen reported to Reyes.

3 151. According to CS 8, Brocade maintained a database, which tracked stock option
4 grants awarded to new hires by Brocade's competitors. Uchida monitored this information to
5 determine whether the number of options granted to new hires compared to similar offers made by
6 those competitors. CS 8 also stated that within this database, Brocade tracked the options given to
7 each Brocade employee through a classification system, which gave the following codes to each
8 type of employee: AA (Senior Executives); A (Vice Presidents); B (Directors and Managers); and
9 every other employee was labeled as a "contributor" with either a "C" (for non-technical
10 employees) or a "T" (for technical employees). C and T level employees were further sub-
11 classified by job level (for example, "C-6"). According to CS 8, Brocade's database used this
12 tracking system to monitor the number of options that could be awarded to each new hire by job
13 level code. CS 8 also stated that Brocade began to implement a new, more generalized,
14 classification system at year-end 2004.

15 152. This statement comports with Brocade's admission in its Restatement, contained in
16 its 2004 year-end Form 10-K, in which Brocade admitted that "there existed material weaknesses in
17 our disclosure controls and procedures in fiscal year 2003 and prior years . . . [and] that those
18 control weaknesses were remedied by the fourth quarter of fiscal year 2003 and that as of October
19 30, 2004, our disclosure controls and procedures were operating effectively."

20 153. According to CS 8, Mike Vescuso replaced Jensen as Vice President of Human
21 Resources in January 2004 after Jensen was removed from this position in December 2003. CS 8
22 became a Staffing Coordinator in May 2004 and held that position through December 2004.
23 Beginning in May 2004, CS 8 was responsible for forwarding new-hire packets to new-hires. As
24 explained by CS 2 and CS 8, new hire packets included "offer letters," as well as other information
25 regarding the benefits being given to each new-hire. Although CS 2 confirmed that the "offer
26 letters" sent by Brocade to new hires through mid-year 2003 contained the exercise price of any
27 options granted to each new hire—and established the offer date as the date for determining the
28 price of such options—CS 8 states that as of May 2004, Brocade had terminated this process such

1 that the exercise price of the stock options granted to each new-hire was no longer stated in the
2 “offer letter.”

3 154. CS 8’s explanation of this material change to Brocade’s practice of setting the
4 exercise price of stock options awarded to new hires, and the timing of this change (after, according
5 to CS 8, Vescuso took over as Vice President of HR, and dramatically changed the HR Department,
6 Brocade no longer included the exercise price in its “offer letters”), is directly in line with the fact
7 that, as announced in Brocade’s Restatement, it had material weaknesses in its internal disclosure
8 controls and procedures from May 1999 until the fourth quarter of 2003 but that such weaknesses
9 were remedied as of October 30, 2004, and ultimately restated four years of its accounting
10 statements because it incorrectly accounted for stock options grants from May 1999 through August
11 2003.

12 155. **Confidential Source 9 (“CS 9”)**: CS 9 was a senior executive, officer level person
13 in charge of information technology at Brocade from 2000 until early 2004. CS 9 worked with and
14 reported directly to Defendant Reyes, Defendant Byrd and Defendant Canova throughout CS 9’s
15 employment with Brocade. According to CS 9, Brocade’s Senior Executives and the Board,
16 specifically Reyes and Byrd in 2000-2001, and thereafter Reyes and Canova, determined the
17 exercise price for stock option grants given to the Company’s employees. CS 9 stated that the
18 specific amount and terms of stock options to be granted to existing employees was within CS 9’s
19 department and were determined by the Board and Officer Defendants in advance of the Board and
20 Senior Executives authorizing CS 9 to distribute such grants within CS 9’s department.

21 156. Therefore, according to CS 9, an individual who worked directly with each of the
22 Officer Defendants at their level of management throughout CS 9’s entire employment at Brocade,
23 from 2000 through early 2004, Reyes, Byrd (2000-2001) and Canova (2001-2004) were directly
24 involved in and had actual knowledge of the exercise price, number of shares, and other terms of
25 stock option grants given to employees.

26 **B. Another Concrete Example of Reyes and Byrd in Action**

27 157. Lead Plaintiff’s review of documents regarding the employment of David Smith,
28 former Brocade Vice President of SAN Integration, Applications and Support, shows exactly how

1 Reyes (and in this instance Byrd) carried out the scheme described by the Confidential Sources set
2 forth above. On January 6, 2000, Reyes sent an official Offer Letter to Smith offering Smith a Vice
3 President Position. Smith lived in Sugar Land, Texas at the time this letter was issued. The Offer
4 Letter was signed by Reyes.

5 158. The Offer Letter offered Smith a base salary of \$240,000.00, plus certain incentive
6 bonuses. The Offer Letter also offered a one-time relocation bonus of \$1,000,000.00, structured as
7 an interest-free loan to be forgiven over the next four years (Smith was required to pay back the
8 loan on a pro-rata basis if he left the Company prior to the expiration of four years). Reyes also
9 stated that Smith would report directly to Reyes.

10 159. The Offer Letter also offered Smith a stock option of 200,000 shares of Common
11 Stock. The Offer Letter expressly stated that the “exercise price of the option will be equal to the
12 fair market value of Brocade’s Common Stock on the grant date, which is your first date of your
13 employment with Brocade.” In the very next sentence, however, the Offer Letter states Smith’s
14 start date is of the date of the Offer Letter, January 6, 2000, and therefore sets the exercise price at
15 the price of the Common Stock that date, \$149.063 per share. And, in the sentence after that, the
16 Offer Letter recognizes that the “vesting of this option will commence upon your start of
17 employment” The Offer Letter also instructs Smith to confer with Stephanie Jensen regarding
18 the details of his employment benefits. Additionally, on April 27, 2000, Byrd signed a letter to
19 Smith formally offering Smith the \$1,000,000.00 loan and setting forth the express terms of that
20 loan.

21 160. This Offer Letter signed by Reyes and the loan letter signed by Byrd show that
22 Reyes, Byrd and Jensen operated exactly as described by Lead Plaintiff’s Confidential Sources.
23 This was a high-level new employee, who was hired “out of guidelines” because he was given a
24 larger salary, bonuses, and a \$1 million loan. The Offer Letter fixed the exercise price of the option
25 grants as of the date of the Offer Letter, January 6, 2000, not the date the Smith actually began
26 working for Brocade, which, according to a Brocade press release, did not occur until April 2000.
27 Smith also signed sworn pleadings in civil litigation against Brocade in which he stated that he
28

1 began work at Brocade in April 2000. The Offer Letter and Loan Letter also show that Byrd, Reyes
 2 and Jensen were directly involved in stock option grants such as this one.

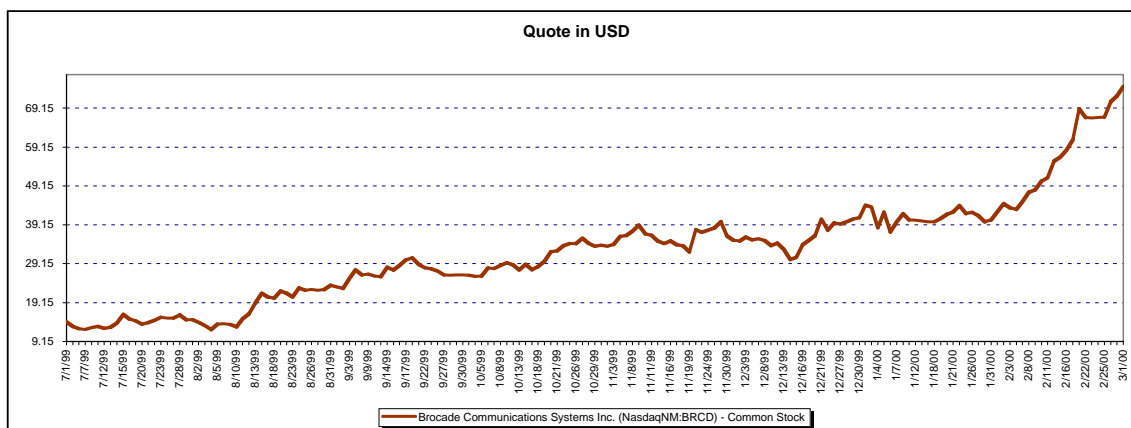
3 161. Further, Lead Plaintiff has learned that Smith was terminated from his employment
 4 at Brocade after he went to Reyes and Byrd and told them that Smith believed they were misleading
 5 shareholders by misrepresenting the Company's financial projections and by committing patent
 6 infringement. Just as Brocade did with Cudgma, it fired Smith when he reported this unlawful
 7 conduct and filed suit against him to try to collect on the \$1 million loan. When Brocade sued
 8 Smith, however, he initiated a whistleblower/wrongful termination suit under California law. That
 9 suit is styled *David Smith v. Brocade Communications Systems*, Case No. CV 807447, Superior
 10 Court of California for the County of Santa Clara.

11 **C. The Officer Defendants' Manipulation Of The Company's Stock Option Plan To**
 12 **Intentionally And Improperly Grant Themselves Lucrative Options In Violation Of**
 13 **The Company's Stock Option Plans**

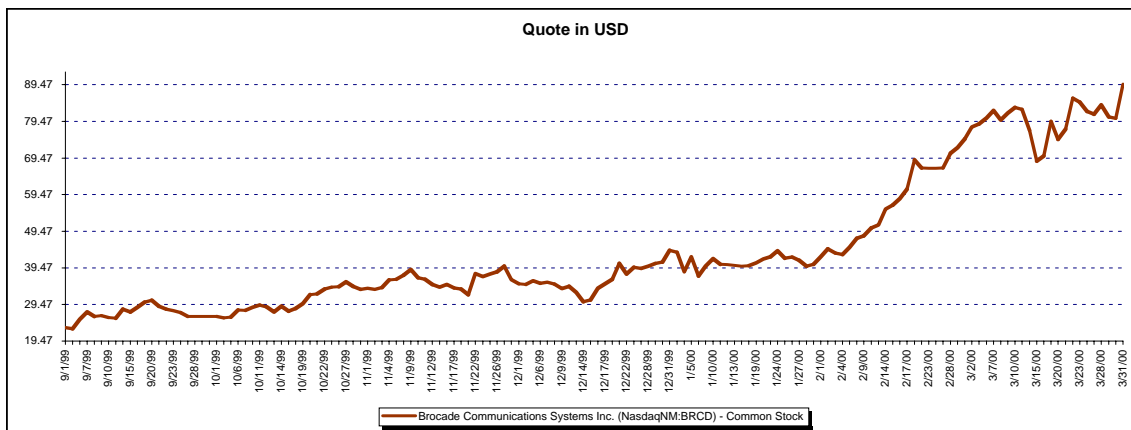
14 162. In 2000-2001, Brocade executed at least four option grants to its Officers when, in
 15 the previous year, the Company made only a single grant. The unique amount and timing of such
 16 grants evidences that Brocade and the Officer Defendants made grants to themselves under the
 17 assumption of generating near-term and/or "guaranteed" returns. Shareholders would lose money
 18 when there was a decline in stock price while management and Brocade's Board freely issued new
 19 options as the old options quickly went underwater. Rather than being an alignment tool, the
 20 options plan appeared in 2001 to be an enrichment tool.

21 163. For example, as the charts below evidence, in a period of less than eleven months
 22 from November 2000 through September 2001, Reyes, Byrd and Canova gave out option awards on
 23 four occasions. Every time, the option awards were granted at a time when the stock had declined
 24 and was in the midst of rising again.

Source	Source Date	Executive	Grants (thousands)	Exercise Price (\$)	Expiration Date	Grant Date (-1 Ex. Date)
DEF 14A	3/15/00	Gregory L. Reyes	0	NA	NA	NA
		Kumar Malavalli	134,000	1.25	2/26/09	3/1/99
		Peter J. Tarrant	200,000	51.7	10/4/09	10/7/99
		Victor M. Rinkle	160,000	1.25	4/1/09	4/4/99
		Charles W. Smith	140,000	0.56	12/7/08	12/10/98



Source	Source Date	Executive	Grants (thousands)	Exercise Price (\$)	Expiration Date	Grant Date (-1 Ex. Date)
DEF 14A	2/26/01					
		Gregory L. Reyes	1,040,000	32.13	11/19/09	11/22/99
		Charles W. Smith	288,328	32.13	11/19/09	11/22/99
		Jack Cuthbert	143,328	32.13	11/19/09	11/22/99
			400,000	40.5	1/31/10	2/3/00
		Michael J. Byrd	85,000	32.13	11/19/09	11/22/99
		Paul R. Bonderson, Jr.	532,000	32.13	11/19/09	11/22/99



Source	Source Date	Executive	Grants (thousands)	Exercise Price (\$)	Expiration Date	Grant Date (-1 Ex. Date)
DEF 14A	2/25/02					
		Gregory L. Reyes	4,800,000	76.88	11/29/10	12/1/00
			3,970,020	20.7	4/17/11	4/19/01
			1,262,113	12.9	10/1/11	10/3/01
		Michael J. Byrd	410,000	76.88	11/29/10	12/1/00
			1,139,050	20.7	4/17/11	4/19/01

1		257,218	12.9	10/1/11	10/3/01
2	Antonio Canova	360,000	68.44	12/21/10	12/23/00
3		377,750	20.7	4/17/11	4/19/01
4	Jack Cuthbert	178,756	12.9	10/1/11	10/3/01
5		542,000	76.88	11/29/10	12/1/00
6	Paul R. Bonderson, Jr.	541,760	20.7	4/17/11	4/19/01
7		205,451	12.9	10/1/11	10/3/01
8		220,000	76.88	11/29/10	12/1/00
9		260,450	20.7	4/17/11	4/19/01
10		5,996	12.9	10/1/11	10/3/01
11	David A. Smith	80,000	76.88	11/29/10	12/1/00
12		207,810	20.7	4/17/11	4/19/01
13		3,826	12.9	10/1/11	10/3/01



Source	Source Date	Executive	Grants(thousands)	Exercise Price (\$)	Expiration Date	Grant Date (-1 Ex. Date)
DEF 14A	2/21/03	Gregory L. Reyes	0	NA	NA	NA
		Michael J. Byrd	0	NA	NA	NA
		Antonio Canova	0	NA	NA	NA
		Jack Cuthbert	0	NA	NA	NA
DEF 14A	2/23/04	Gregory L. Reyes	1,103,214	6.54	7/10/13	7/13/03
			600,000	5.53	8/15/10	8/17/03
		Antonio	545,149	6.54	7/10/13	7/13/03

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Canova	150,000	5.53	8/15/10	8/17/03
Jack Cuthbert	867,593	6.54	7/10/13	7/13/03
Michael Klayko	300,000	5.53	8/15/10	8/17/03
463,781	4.55	1/27/13	1/30/03	
250,000	5.53	8/15/10	8/17/03	
James LaLonde	474,430	6.54	7/10/13	7/13/03
100,000	5.53	8/15/10	8/17/03	

(*) = Options appear to have 7 year life.



164. This type of options activity is highly unusual and evidences that the Officer Defendants were manipulating the Stock Option Plan to grant themselves options whenever the stock price dropped, so that they would have a lower exercise price.

165. Indeed, according to a study of executives who received option grants on downturns in stock prices at seven companies during the tech-boom (Brocade was not included in this study) set forth in the article “The Perfect Pay Day,” Charles Forelle and James Bandler, *Wall Street Journal*, March 18, 2006, the odds of a company randomly issuing stock option grants to officers at times when stock price had taken a downturn were greater than 1 in a billion. The reason for this is simple. As pointed out in “The Perfect Pay Day”

1 Which day’s price the options carry makes a big difference. Suppose
 2 an executive gets 100,000 option on a day when the stock is at \$30.
 3 Exercising them after it has reached \$50 would bring a profit of \$20
 4 times 100,000, or \$2 million. But if the grant date was a month
 5 earlier and the stock then was at, say, \$20, the options would bring in
 6 an extra \$1 million.

7 *Id.*

8 166. Here, as the Company’s own Restatement concedes, the lack of internal controls
 9 regarding options grants allowed the Officer Defendants to grant themselves options whenever they
 10 chose and, indeed, they were not even restricted from granting themselves options even at times
 11 when they were restricted from insider trading. Additionally, this activity, together with the
 12 information provided by CS 1, suggests that the Company was backdating option grant dates to
 13 guarantee returns to the Officer Defendants. To say the least, the fact that these Officers were able
 14 to specifically grant themselves options at such opportunistic times during 2001 is highly
 15 conspicuous and unusual.

16 **D. Certain Individual Defendants’ Insider Trading**

17 167. Collectively, certain of the Individual Defendants enriched themselves by hundreds
 18 of millions of dollars in insider trading proceeds during the Class Period. Specifically, certain of
 19 the Individual Defendants profited as follows:

20	Reyes	\$167,600,948
21	Canova	\$31,526
22	Byrd	\$43,970,932
23	Dempsey	\$10,615,948
24	Leslie	\$97,116,605
25	Neiman	\$125,571,454
26	Sonsini	\$2,058,289

27 168. These Defendants made multi-million dollar insider trading transactions at a time
 28 when the price of Brocade stock was substantially inflated due to the materially misleading
 statements contained in its Financial Statements. These Defendants’ enormous profits from these
 transactions further evidences not only these Defendants’ knowledge and participation of the

1 pervasive scheme going on at Brocade during the Class Period, but also shows why they did it.
2 Indeed, had the true information regarding Brocade's financial condition been released during this
3 time, these Defendants clearly would not have made such huge proceeds, if any at all. When the
4 truth was finally revealed, the stock dropped 46%. Had Defendants told the truth during the Class
5 Period, it would have cut their profits by at least this much, if not eliminated them all together.
6 These Defendants' personal stake in the performance of Brocade stock and the resulting millions
7 that they earned is yet another factor contributing to the mounting evidence of these Defendants'
8 *scienter*.

9 **E. Brocade's Grants Of Loans To Reyes And Byrd And Other Employees**

10 169. Defendants "rewarded" new-hires and existing employees with significant monetary
11 loans, which were secured with nothing more than the employee's unexercised options as collateral.
12 Under these loan agreements, the Company would loan money to an employee, and the employee
13 would in return agree to exercise or cash in his or her options when the loan came due. However,
14 the loan agreements also required the employee to pay the loan in full, pursuant to an acceleration
15 clause, if the employee quit working for Brocade or was terminated by the Company. This method
16 of loaning money to employees was particularly risky to the Company because if an employee quit
17 or was terminated before his or her options had fully vested, he or she could not actually exercise
18 the options. Further, if the options were "not in the money" when the acceleration clause kicked in,
19 the options used as collateral would be worthless. As such, the Company and the employees who
20 received these loans had a tremendous, and unusual incentive, to manipulate the process of granting
21 options to recipients of loans such that the grant date would be as early as possible and the exercise
22 price would be as low as possible, in order to (1) make the options vest earlier and (2) increase the
23 likelihood that any such options would be "in the money" in the event the acceleration clause ever
24 kicked in.

25 170. The Company disclosed that it loaned money to certain employees from time to time.
26 The Company also claimed that these loans were properly secured by collateral. The Company
27 omitted, however, that this collateral was actually nothing more than unvested options granted in
28 violation of the Company's Stock Option Plan. Thus, investors could not know the true cost or risk

1 of such loans and also were not aware that the Company and Officer Defendants had a significant
2 need to manipulate the Company's stock price by falsely reporting the truth about the stock option
3 grants at issue in this case, because, if the Company's stock price dropped, these options would not
4 be "in the money" and, as such, the Company would get nothing if it accelerated one of these loans.

5 171. For example, on February 26, 2001, Brocade issued a loan for \$300,000.00 to a
6 Brocade employee whose name is being withheld for confidentiality reasons. The loan was secured
7 by a pledge by the employee of 28,000 shares of stock granted to the employee under the NSO Plan.
8 Pursuant to this loan agreement, Brocade retained the right to call the loan due if the employee quit
9 or was terminated, and, upon such event, the employee was required to exercise the 28,000 options
10 to cover the loan. One obvious problem with this arrangement, however, is that pursuant to the
11 NSO, these options vested on a year after year basis, and, as such, if the options had not vested, or
12 those that had vested were not sufficiently "in the money", the Company would have no collateral
13 to collect against the loan amount.

14 172. Due to the harmful effect such a loan would have on the Company in the event the
15 employee was terminated before his or her options fully vested and/or if such options were not
16 sufficiently "in the money" to cover such a loan, in which case the Company would be out the entire
17 amount of the loan with no recourse due to the lack of a real security interest as collateral, the use of
18 such loans provided unique additional motive and opportunity for the Company and Officer
19 Defendants to carry out their pervasive stock option grants scheme.

20 173. Moreover, Defendants Reyes and Byrd used the options scheme to ensure their
21 ability to repay massive loans of cash which were secured by nothing more than options granted to
22 themselves. The Company had loaned \$1.65 million to former CFO Byrd, which was secured by
23 his purchase of 1,320,000 shares of Brocade stock, granted to him pursuant to the NSO at a strike
24 price of \$1.25 per share. This loan accrued interest at the rate of 5.21% annually and was not due
25 until April 1, 2006. The Company also loaned Reyes \$647,854.00 secured by a stock pledge
26 agreement on his purchase of 1,151,740 shares of the Company's stock with a \$0.56 strike price and
27 another \$2,807,386 secured by a stock pledge agreement on his purchase of 4,990,908 shares at a
28 strike price of \$0.56. These loans had a maturity date of May 24, 2000.

1 174. As a result, both Byrd and Reyes had a significant motive and opportunity to
2 manipulate the Company's Financial Statements, as they did in fact, in order to help themselves pay
3 back these loans.

4 **F. The Audit Committee's Knowledge Or Deliberately Reckless Disregard Of Brocade's**
5 **False Accounting For And Disclosure Of Stock Option Grants**

6 175. The Audit Committee Defendants acted recklessly in the performance of their duties
7 and, as a direct result, facilitated the rampant accounting fraud and utter lack of internal controls at
8 Brocade described herein. The following Defendants served on Brocade's Audit Committee during
9 the Class Period:

- 10 2000: Neiman and Dempsey
- 11 2001: Neiman and Dempsey
- 12 2002: Dempsey, Leslie, and Sonsini
- 13 2003: Dempsey, Paisley (Chairman), and Sonsini
- 14 2004: Dempsey, Moore, and Paisley (Chairman)

15 176. The vital importance of audit committees to the integrity of a company's financial
16 reporting was emphasized by the SEC in the rules promulgated pursuant to the Sarbanes Oxley Act
17 of 2002:

18 The audit committee, composed of members of the board of directors,
19 plays a critical role in providing oversight over and serving as a check
20 and balance on a company's financial reporting system. The audit
21 committee provides independent review and oversight of a company's
22 financial reporting processes, internal controls and independent
23 auditors. It provides a forum separate from management in which
24 auditors and other interested parties can candidly discuss concerns.
By effectively carrying out its functions and responsibilities, the audit
committee helps to ensure that management properly develops and
adheres to a sound system of internal controls, that procedures are in
place to objectively assess management's practices and internal
controls, and that the outside auditors, through their own review,
objectively assess the company's financial reporting practices.

25 177. Even prior to the enactment of Sarbanes Oxley, Brocade described the important
26 rules and responsibilities of the Audit Committee in its 2001 Schedule 14A Proxy Statement filed
27 with the SEC:

28

1 The audit committee makes recommendations to the Company's
2 Board of Directors regarding the selection of independent auditors,
3 reviews the results and scope of audit and other services provided by
4 the Company's independent auditors **and reviews the accounting
principles and auditing practices and procedures to be used for
the Company's financial statements.** (emphasis added).

5 178. Of all the Board's committees, the Audit Committee had the greatest responsibility
6 for the oversight of Brocade's accounting for and disclosure of stock option grants and for the
7 presence of internal processes, controls and procedures regarding those grants. Indeed, it was
8 fundamental that the Audit Committee Defendants have a detailed understanding of the Company,
9 and particularly the adequacy of its financial systems and internal controls.

10 179. Moreover, Brocade's Stock Option Plans specifically charged Brocade's Board of
11 Directors with the responsibility of carrying out the Company's Stock Option Plans according to the
12 requirements of the Plans and in compliance with the federal securities laws. Clearly, as evidenced
13 by Brocade's own Restatement, the Audit Committee Defendants failed this task miserably.

14 180. In this regard, the Audit Committee Defendants knew, or were deliberately reckless
15 in not knowing, that Brocade improperly accounted for and disclosed stock option grants.
16 Moreover, the Audit Committee Defendants knew or were deliberately reckless in disregarding that
17 the Company's financial systems and internal controls were grossly inadequate.

18 181. The Audit Committee Defendants acted recklessly in allowing Brocade to make the
19 statements identified in Section VIII, *infra*, without ensuring that the necessary internal controls
20 existed to guarantee that those statements were free from material error. Indeed, according to the
21 Proxy Statement referenced above, it was the stated responsibility of the Audit Committee to
22 discuss those controls with Brocade's management and with the Company's outside auditor,
23 KPMG.

24 182. Brocade admitted in its Restatement that its internal controls and disclosure
25 procedures regarding Brocade's stock option granting process were flawed during the Class Period.
26 See Brocade's SEC Form 10-K filed January 31, 2005, pp. 83-84, Item 9A. Brocade admitted that
27 these controls were so fundamentally flawed that the Company's Financial Statements could not be
28 relied upon for the entire Class Period and that these flaws were not remedied until the end of

1 Brocade's fiscal year 2004. *Id.* Brocade further announced that significant changes were made to its
2 Disclosure Controls and Internal Controls over Financial Reporting and the stock option grant
3 process, which were not in place during all or part of the Class Period. *Id.* These changes and
4 additions, which are set forth in detail above, are significant because they establish that such
5 internal controls, processes and procedures **were not** in place during the relevant parts of the Class
6 Period.

7 183. The Company's own Restatement clearly admits that Brocade's internal controls and
8 processes for the accounting for, and disclosure of, option grants not only were not good during the
9 Class Period but, in fact—by the Company's own admission—were simply non-existent. The fact
10 that the Company has made these concessions that these internal controls were non-existent is
11 conclusive proof as to the Audit Committee's *scienter*. The Audit Committee Defendants were
12 charged with knowing these controls, making sure they were appropriate, and remedying any
13 related problems. Had the Audit Committee Defendants conducted any investigation of those
14 controls, or engaged in any substantive discussion of the adequacy of those controls with
15 management or with outside auditor Arthur Anderson or later KPMG, they would have necessarily
16 discovered the inadequacy of those controls and implemented controls sufficient to have prevented
17 the perpetration of the misconduct alleged herein. The fact that the Audit Committee Defendants
18 either were aware of these failures and chose to ignore them, or simply failed to conduct the
19 necessary, and required, investigation, is incontrovertible evidence of their knowledge or reckless
20 disregard of the wrongdoing at Brocade.

21 184. Further, Brocade's Stock Option Plans filed with the SEC, which are discussed in
22 detail above, specifically mandated that Brocade's Board of Directors be in charge of stock option
23 grants for the entire Class Period. The Plans expressly require that the Board, in its entirety, or
24 through a specifically appointed Committee thereof, control granting of stock option grants and
25 ensure that such grants are awarded, accounted for, and disclosed in compliance with the Plans and
26 federal law. However, Defendant Reyes' own comments that Audit Committee Defendant Larry
27 Sonsini granted Reyes complete authority to "dole out" stock option grants as Reyes deemed
28 appropriate is, in and of itself, evidence that the Audit Committee in general, and Defendant Sonsini

1 in particular, violated the Company's own Stock Option Plans and acted with actual awareness
2 and/or deliberate recklessness. Moreover, the Restatement admits there was no written guideline
3 setting forth the appropriate procedures to be used for granting options from 1999-2004. The
4 evidence provided by Lead Plaintiff's Confidential Sources, which also is set forth above, further
5 supports that the Audit Committee Defendants allowed the Officer Defendants to grant stock
6 options with little or no oversight by the Board or the Audit Committee.

7 185. As set forth in great detail above, Brocade engaged in a number of improper stock
8 option grants during the Class Period, which caused five years of Brocade's Financial Statements to
9 be materially false and misleading. Had the Audit Committee undertaken to investigate any of
10 these transactions, as it did once it became aware of the SEC's and Department of Justice's joint
11 investigation into these issues, it would have uncovered the wrongdoing that, in 2005, caused
12 Brocade to dismiss Reyes as CEO and Chairman and restate Brocade's Financial Statements. That
13 the Audit Committee Defendants were readily able to uncover the fraud when they finally decided
14 to perform their proper function in late 2004 and early 2005 under threat of a governmental
15 investigation, demonstrates that they knowingly and/or willfully failed to perform their duty for
16 more than four years so as to permit Brocade to falsify its Financial Statements over that extended
17 period.

18 **G. KPMG's Knowledge Or Deliberately Reckless Disregard Of Brocade's Improper**
19 **Accounting For And Disclosure Of Stock Option Grants**

20 186. KPMG was Brocade's "independent auditor" during most of the Class Period
21 (commencing June 18, 2002) and in accordance with GAAP, was charged with the responsibility of
22 opining upon whether or not Brocade prepared its Financial Statements in accordance with GAAP.
23 As set forth below, however, Brocade's Financial Statements, as evidenced by Brocade's
24 Restatement, failed to comply with GAAP in many respects. Moreover, as Brocade has admitted,
25 during the Class Period it failed to maintain even minimal internal controls to ensure that its
26 accounting complied with GAAP. Thus, in certifying that Brocade's Financial Statements during
27 the Class Period fairly represented Brocade's financial condition and results of operations, in all
28 material respects, in conformity with GAAP, KPMG knowingly or recklessly ignored material

1 internal control deficiencies at Brocade. Those material internal control deficiencies, had they been
2 examined by KPMG, should have alerted it to the fact that Brocade's financial reporting practices
3 violated GAAP and its Financial Statements were materially false and misleading.

4 187. KPMG is a worldwide firm of certified public accountants, auditors and consultants
5 which provides a variety of accounting, auditing, and consulting services. KPMG served as
6 Brocade's independent auditor and principal accounting firm during, most of the Class Period and
7 relied upon, without adverse comment, the prior opinions of Arthur Andersen & Co., Brocade's
8 previous outside auditors. KPMG acted in these capacities pursuant to the terms of contracts it had
9 with Brocade that, among other things, required KPMG to audit Brocade's Financial Statements in
10 accordance with Generally Accepted Auditing Standards ("GAAS"), and to report the results of
11 those audits to Brocade, its Board of Directors and the members of the investing public, including
12 Lead Plaintiff and the members of the Class.

13 188. KPMG was engaged by Brocade to provide independent accounting, consulting and
14 auditing services to Brocade and to give Brocade accounting advice and consultation regarding
15 Brocade's annual and quarterly reports which were filed with the SEC and publicly distributed.
16 KPMG, by virtue of its position as outside accountant and auditor of Brocade, had access to the files
17 and key officers and employees of the Company at all relevant times. As a result of the auditing
18 and other services it provided to Brocade, KPMG personnel were frequently present at Brocade's
19 corporate headquarters throughout each year, had continual access to and knowledge of Brocade's
20 confidential internal corporate, financial, operating, and business information, and had the
21 opportunity to observe and review the Company's business and accounting practices, and to test the
22 Company's internal accounting information and publicly reported financial statements as well as the
23 Company's internal controls and structures.

24 189. For this service to Brocade, and for numerous other non-audit services, KPMG was
25 highly compensated. KPMG earned \$240,000 in auditing fees (and \$88,000 in other fees) for fiscal
26 year 2003, \$304,000 in auditing fees (and \$708,000 in other fees) for fiscal year 2004, and \$596,000
27 in auditing fees (and \$137,000 in other fees) for fiscal year 2005. Thus, from its engagement in
28 June 18, 2002 through fiscal year 2004, KPMG was paid \$1.14 million in auditing fees alone.

1 KPMG was paid other fees during this same period totaling \$933,000, which other fees included
2 “consultations concerning financial accounting and reporting standards”, “tax compliance and tax
3 planning” and “technical tax advice.” The audit fees included charges for “preparation of an annual
4 ‘management letter’ on internal control matters.”

5 190. Interestingly, Brocade paid KPMG an additional \$2,424,000 for fiscal year 2005. In
6 its recently filed proxy statement, Brocade stated that it paid KPMG \$1,256,000.00 for audit fees
7 and \$1,168,000.00 for “all other fees.” The payment for “all other fees” was payment for KPMG’s
8 role in the Audit Committee review, investigation and Restatement completed November 2005
9 regarding the Company’s stock option accounting practices. An auditor who deliberately or
10 recklessly signs off on such fraudulent Financial Statements at issue here, should not be able to
11 make even more money—here to the tune of over \$1 million—to actually go back and do an
12 investigation that confirms that the very same Financial Statements it previously audited and signed
13 off on were, in fact, materially false and misleading.

14 191. An auditor is required to perform its audits in accordance with GAAS. The AICPA’s
15 Auditing Standards Board has also developed Statements on Auditing Standards, which serve as
16 “interpretations of generally accepted auditing standards.” AU § 100 states:

17 The objective of the ordinary audit of financial statements by the
18 independent auditor is the expression of an opinion on the fairness
19 with which they present, in all material respects, financial position,
20 results of operations, and its cash flows in conformity with generally
21 accepted accounting principles. The auditor’s report is the medium
22 through which he expresses his opinion or, if circumstances require,
23 disclaims an opinion. In either case, he states whether his audit has
24 been made in accordance with generally accepted auditing standards.
25 These standards require him to state whether, in his opinion, the
26 financial statements are presented in conformity with generally
27 accepted accounting principles and to identify those circumstances in
28 which such principles have not been consistently observed in the
preparation of the financial statements of the current period in relation
to those of the preceding period.

192. When an auditor represents that a company’s financial statements conform in all
material respects with GAAP, the auditor “indicates [his] belief that the financial statements taken
as a whole are not materially misstated.” AU § 312. Indeed, “[f]inancial statements are materially
misstated when they contain misstatements whose effect, individually or in the aggregate, is

1 important enough to cause them not to be presented fairly, in all material respects, in conformity
2 with [GAAP].” AU § 312.

3 193. Despite the numerous GAAP violations evident in Brocade’s Financial Statements
4 during the Class Period, KPMG issued unqualified opinions, representing that the Financial
5 Statements were presented fairly, in all material respects, and in accordance with GAAP from June
6 18, 2002 through the Class Period. KPMG’s Audit Report dated November 18, 2002, reporting on
7 Brocade’s Financial Statements as of and for the year ending October 26, 2002, was filed with the
8 SEC on January 22, 2003. In its Audit Report regarding Brocade’s 2002 Financial Statements,
9 KPMG stated:

10 We have audited the accompanying consolidated balance sheet of
11 Brocade Communications Systems, Inc. and subsidiaries as of
12 October 26, 2002, and the related consolidated statements of
13 operations, stockholders’ equity and cash flows for the year then
14 ended. In connection with our audit of the consolidated financial
15 statements, we have also audited the related financial statement
16 schedule listed in Item 15(a)2. These consolidated financial
17 statements and related financial statement schedule are the
18 responsibility of the Company’s management. Our responsibility is to
19 express an opinion on these consolidated financial statements and
20 related financial statement schedule based on our audit. The
21 accompanying consolidated balance sheet of Brocade
22 Communications Systems, Inc. and subsidiaries as of October 27,
23 2001, and the related consolidated statements of operations,
24 stockholders’ equity and cash flows for each of the years in the two-
25 year period ended October 27, 2001, and related financial statement
26 schedule were audited by other auditors who have ceased operations.
27 Those auditors expressed an unqualified opinion on those
28 consolidated financial statements and related financial statement
schedule in their report dated November 20, 2001.

21 We conducted our audit in accordance with auditing standards
22 generally accepted in the United States of America. Those standards
23 require that we plan and perform the audit to obtain reasonable
24 assurance about whether the financial statements are free of material
25 misstatement. An audit includes examining, on a test basis, evidence
26 supporting the amounts and disclosures in the financial statements.
27 An audit also includes assessing the accounting principles used and
28 significant estimates made by management, as well as evaluating the
overall financial statement presentation. We believe that our audit
provides a reasonable basis for our opinion.

27 In our opinion, the consolidated financial statements referred to above
28 present fairly, in all material respects, the financial position of
Brocade Communications Systems, Inc. and subsidiaries as of

1 October 26, 2002, and the results of their operations and their cash
2 flows for the year then ended in conformity with accounting
3 principles generally accepted in the United States of America. Also,
4 in our opinion the related financial statement schedule for the year
5 ended October 26, 2002, when considered in relation to the
6 consolidated financial statements taken as a whole presents fairly, in
7 all material respects, the information set forth therein.

8 194. KPMG’s audit report dated November 14, 2003, reporting on Brocade’s Financial
9 Statements as of and for the years ended October 25, 2003 and October 26, 2002, was filed with the
10 SEC on January 20, 2004. In its audit report regarding Brocade’s 2003 and 2002 financials, KPMG
11 stated:

12 We have audited the accompanying consolidated balance sheet of
13 Brocade Communications Systems, Inc. and subsidiaries as of
14 October 25, 2003 and October 26, 2002, and the related consolidated
15 statements of operations, stockholders’ equity and comprehensive
16 income (loss), and cash flows for each of the years in the two-year
17 period ended October 25, 2003. In connection with our audit of the
18 consolidated financial statements, we have also audited the related
19 financial statement schedule listed in Item 15(a)2. These consolidated
20 financial statements and related financial statement schedule are the
21 responsibility of the Company’s management. Our responsibility is to
22 express an opinion on these consolidated financial statements and
23 related financial statement schedule based on our audit. The
24 accompanying consolidated statements of operations, stockholders’
25 equity and comprehensive income (loss) and cash flows for the year
26 ended October 27, 2001 and related financial statement schedule were
27 audited by other auditors who have ceased operations. Those auditors
28 expressed an unqualified opinion on those consolidated financial
 statements and related financial statement schedule in their report
 dated November 20, 2001.

 We conducted our audit in accordance with auditing standards
 generally accepted in the United States of America. Those standards
 require that we plan and perform the audit to obtain reasonable
 assurance about whether the financial statements are free of material
 misstatement. An audit includes examining, on a test basis, evidence
 supporting the amounts and disclosures in the financial statements.
 An audit also includes assessing the accounting principles used and
 significant estimates made by management, as well as evaluating the
 overall financial statement presentation. We believe that our audit
 provides a reasonable basis for our opinion.

 In our opinion, the consolidated financial statements referred to above
 present fairly, in all material respects, the financial position of
 Brocade Communications Systems, Inc. and subsidiaries as of
 October 25, 2003 and October 26, 2002, and the results of their
 operations and their cash flows for each of the years in the two-year
 period ended October 25, 2003, in conformity with accounting
 principles generally accepted in the United States of America. Also,

1 in our opinion the related financial statement schedule for the years
2 ended October 25, 2003 and October 26, 2002, when considered in
3 relation to the consolidated financial statements taken as a whole
presents fairly, in all material respects, the information set forth
therein.

4 195. KPMG’s audit report dated January 27, 2005, reporting on Brocade’s Financial
5 Statements as of and for the years ending October 30, 2004 and October 25, 2003, and included in
6 Brocade’s 2005 10-K, stated:

7 We have audited the accompanying consolidated balance sheets of
8 Brocade Communications Systems, Inc. and subsidiaries (the
9 Company) as of October 30, 2004 and October 25, 2003, and the
related consolidated statements of operations, stockholders’ equity
10 and comprehensive income (loss), and cash flows for each of the
years in the three-year period ended October 30, 2004. In connection
with our audit of the consolidated financial statements, we have also
11 audited the related financial statement schedule listed in Item 15(2).
These consolidated financial statements and related financial
12 statement schedule are the responsibility of the Company’s
management. Our responsibility is to express an opinion on these
consolidated financial statements and related financial statement
13 schedule based on our audit.

14 We conducted our audit in accordance with auditing standards
generally accepted in the United States of America. Those standards
15 require that we plan and perform the audit to obtain reasonable
assurance about whether the financial statements are free of material
16 misstatement. An audit includes examining, on a test basis, evidence
supporting the amounts and disclosures in the financial statements.
17 An audit also includes assessing the accounting principles used and
significant estimates made by management, as well as evaluating the
18 overall financial statement presentation. We believe that our audit
provides a reasonable basis for our opinion.

19
20 In our opinion, the consolidated financial statements referred to above
present fairly, in all material respects, the financial position of
21 Brocade Communications Systems, Inc. and subsidiaries as of
October 30, 2004 and October 25, 2003, and the results of their
22 operations and their cash flows for each of the years in the three-year
period ended October 30, 2004, in conformity with accounting
23 principles generally accepted in the United States of America. Also,
in our opinion the related financial statement schedule, when
24 considered in relation to the consolidated financial statements taken as
a whole, presents fairly, in all material respects, the information set
25 forth therein.

26 As discussed in Note 3 to the accompanying consolidated financial
statements, the consolidated balance sheet of Brocade
27 Communications Systems, Inc. and subsidiaries as of October 25,
2003, and the related consolidated statements of operations,
28 stockholders’ equity and comprehensive income (loss) and cash flows

1 for each of the years in the two year period ended October 25, 2003
2 have been restated.

3 196. In issuing unqualified audit opinions on Brocade's Financial Statements, despite
4 Brocade's consistent GAAP violations throughout the Class Period, KPMG either acted knowingly,
5 or was deliberately reckless, in failing to comply with the professional standards dictated by GAAS
6 (AU § 150) including:

- 7 i. General Standard No. 1, which requires an audit be performed by a person or persons
8 having adequate technical training and proficiency as an auditor;
- 9 ii. General Standard No. 2, that requires that an auditor possess an independence in
10 mental attitude in all matters related to the assignment;
- 11 iii. General Standard No. 3, which requires that due professional care is to be exercised
12 in the performance of the audit and the preparation of the report;
- 13 iv. Standard of Field Work No. 1, which requires that the auditor's work be adequately
14 planned and audit staff properly supervised;
- 15 v. Standard of Field Work No. 2, which requires the auditor gain a sufficient
16 understanding of internal controls in order to plan the audit, including accounting,
17 financial and managerial controls, to determine whether reliance thereon is justified,
18 and if such controls are not reliable, to expand the nature and scope of the auditing
19 procedures to be applied;
- 20 vi. Standard of Field Work No. 3, which requires sufficient competent evidential matter
21 is to be obtained through inspection, observation, inquiries, and confirmations to
22 afford a reasonable basis for an opinion regarding the financial statements under
23 audit;
- 24 vii. Standard of Reporting No. 1, which requires an audit report to state whether the
25 financial statements are presented in accordance with GAAP;
- 26 viii. Standard of Reporting No. 3, which requires that informative disclosures in the
27 financial statements are to be regarded as reasonably adequate unless otherwise
28 stated in the report; and

1 ix. Standard of Reporting No. 4, which requires that, when an opinion on the financial
2 statements as a whole cannot be expressed, the reasons therefore must be stated.

3 197. Brocade has admitted that its Financial Statements during the Class Period did not
4 comply with GAAP. Indeed, the Restatement establishes a pervasive dereliction by Brocade's
5 management in complying with the basic requirements of GAAP. Therefore, KPMG's unqualified
6 opinions during the Class Period, stating that Brocade's Financial Statements did comply with
7 GAAP, were simply false and violated GAAS. As shown below, KPMG's failure to detect
8 Brocade's extensive long-term accounting violations and omissions can only be the product of
9 severe recklessness as to whether Brocade's Financial Statements complied with GAAP, or a total
10 disregard of its duty to perform a proper audit of the Company's Financial Statements.

11 198. Brocade failed to take any reasonable steps to ensure that its audit opinion was
12 accurate. KPMG failed to consider the sufficiency of Brocade's internal controls, did not take
13 notice of red flags that warned of potential problems with Brocade's accounting, and failed to plan
14 its audits and perform even a cursory review of evidential matter to detect instances of material
15 omissions and misstatements. For these severely reckless and/or knowing failures, KPMG violated
16 the securities laws.

17 **1. KPMG's Utter Failure to Assess the Sufficiency of Brocade's Internal Controls**
18 **Rendered its Unqualified Audits Severely Reckless**

19 199. On January 24, 2005, Brocade's Audit Committee completed its investigation of
20 Brocade's internal controls as part of its investigation into Brocade's materially deficient and
21 misleading accounting practices and concluded, with its auditor, KPMG, that it would be necessary
22 to restate its financial statements from 1999 through 2004 to account properly under GAAP.
23 Brocade stated in its January 27, 2005 10-K report filed with the SEC:

24 Based upon this evaluation, as of the Evaluation Date, our Chief
25 Executive Officer and Chief Financial Officer have concluded that
26 there existed material weaknesses in our disclosure controls and
27 procedures in fiscal year 2003 and prior years, as detailed below. Our
28 Chief Executive Officer and Chief Financial Officer have further
concluded and that those control weaknesses were remedied by the
fourth quarter of fiscal year 2003 and that as of October 30, 2004, our
disclosure controls and procedures were operating effectively.

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Our failure to continue to improve upon our operational, managerial, and financial controls, enterprise-wide management information and reporting systems, and procedures, and our failure to continue to train and manage our workforce worldwide, could seriously harm our business and financial results.

200. This lack of internal controls at Brocade is evidenced by the blatant and obvious omissions of material fact regarding the true nature of these improper stock option grants that were rampant at the Company during the Class Period. Despite Brocade’s statements in the January 31, 2005 10-K report that “disclosure controls and procedures were operating effectively” as of October 30, 2004, Brocade was required to amend its January 31, 2005 10-K and again restate its Financial Statements in November 2005 for the 2004-2005 periods. The millions of dollars in stock option grants expense that Brocade failed to accrue or account for during this extended period, covering four fiscal years, further underscores the lack of controls over Brocade’s accounting procedures, and KPMG’s inexplicable inability and failure to detect the obvious problems in internal controls.

201. Indeed, in its amended 10-K filed November 14, 2005, Brocade’s management admitted that Brocade’s KPMG-audited Financial Statements, as submitted to the SEC January 31, 2005, could not be relied upon and that there existed “material weaknesses” in internal controls:

In May 2005, we determined that our financial statements for the fiscal years ended October 30, 2004, October 25, 2003, and October 26, 2002, and the interim periods contained therein, should no longer be relied upon because of errors in such financial statements.

More specifically, following the completion of an Audit Committee review announced on January 24, 2005 and the related restatement...additional information came to our attention that indicated that we could not rely on the documentation used to support the recorded measurement dates for stock options granted in the period from August 2003 through November 2004.

Based on this evaluation, as of the Evaluation Date, our Chief Executive Officer and Chief Financial Officer concluded that there existed material weaknesses in our disclosure controls and procedures as of October 30, 2004 and, therefore, our disclosure controls and procedures were not operating effectively as of such date...

1 202. KPMG's reckless indifference to Brocade's utter lack of internal controls violated
2 GAAS. Under GAAS, an independent auditor is obligated to gain a sufficient understanding of an
3 entity's internal control structure in order to adequately plan the audit and to determine the nature,
4 timing and extent of tests to be performed. *See* AU § 150.02. In all audits, the auditor should
5 perform procedures to obtain a sufficient understanding of three elements of an entity's internal
6 control structure: the control environment, the accounting system, and control procedures. AU §
7 319.02. The control environment, which includes management's integrity and ethical values, is the
8 foundation of internal control and provides discipline, structure and sets the tone of an organization.
9 After obtaining an understanding of an entity's internal control structure, the auditor must assess the
10 entity's control risk. AU § 319.02. The control risk is the risk that a material misstatement in an
11 assertion by management contained in a company's financial statements will not be prevented or
12 detected on a timely basis by an entity's internal control structure policies or procedures. AU
13 §319.29. The ultimate purpose of assessing control risk is to aid the auditor in evaluating the risk
14 that material misstatements exist in the financial statements. AU § 319.61.

15 203. Under AU § 722.10, the auditor needs to have sufficient knowledge of a client's
16 internal control as it relates to the preparation of both annual and interim financial information to:
17 identify types of potential material misstatements in the interim information and consider the
18 likelihood of their occurrence, select inquiries and procedures that will provide a basis for reporting
19 whether material modifications should be made for the information to conform with GAAP.

20 204. KPMG failed to adequately test internal controls at Brocade. This prevented it from
21 having a sufficient knowledge of Brocade's internal controls to allow KPMG to assess the
22 likelihood and type of potential misstatement in the interim Financial Statements. Additionally,
23 KPMG failed to develop and perform adequate analytical procedures and inquiries (AU § 722.13)
24 designed to identify the need for material modifications to the interim Financial Statements.

25 205. It is apparent from the conclusions by Brocade's Audit Committee that the most
26 cursory scrutiny of Brocade's internal controls would have revealed that such controls were wholly
27 lacking at the Company. Yet, KPMG, in the course of reviewing Brocade's Financial Statements
28 for 2001, and auditing Brocade's 2002 through 2004 Financial Statements, knowingly or recklessly

1 disregarded weaknesses and deficiencies in Brocade's internal control structure. Had KPMG
2 complied with GAAS, it should have discovered that there were: (a) insufficient numbers of
3 personnel having appropriate knowledge, experience and training in the application of GAAP at the
4 appropriate levels, and insufficient personnel at the Company's headquarters to provide effective
5 oversight and review of financial transactions; (b) ineffective or inadequate accounting policies to
6 ensure the proper and consistent application of GAAP throughout the organization; (c) ineffective
7 or inadequate controls over the administration and related accounting treatment for stock based
8 compensation and stock options generally; and (d) ineffective "tone" within the organization related
9 to the discouragement, prevention or detection of management override; as well as (e) inadequate
10 emphasis on thorough and proper knowledge, understanding and analysis of stock and financial
11 transactions.

12 **2. Numerous "Red Flags" Should Have Alerted KPMG to Brocade's False and**
13 **Misleading Financial Statements**

14 206. Had KPMG conducted its audits in accordance with GAAS, it would have
15 discovered that Brocade's Financial Statements were materially false and misleading and failed to
16 comply with GAAP. AU Section 316 requires auditors to consider and evaluate the risks that a
17 company's audited financial statements are free of material misstatements, whether by fraud or by
18 error, and identifies various "red flags" that the auditors need to consider in determining audit risk
19 relating to misstatements arising from fraudulent reporting. In addition to the lack of internal
20 controls, described above, other red flags, should have alerted KPMG to the potential of material
21 misstatement arising from fraudulent financial reporting at the Company. These red flags included:

- 22 a. Un-expensed management, director and employee stock option grants not in
23 proportion to compensation, production, contribution or other rational measurement, leading to
24 staggering expense liability on proper accounting under GAAP;
- 25 b. A failure of Brocade's management to display and communicate an appropriate
26 attitude regarding internal controls and the financial reporting process; and
- 27 c. The lack of effective accounting, information technology, or internal auditing staff.
- 28

1 Each of these red flags should have alerted KPMG to Brocade's incorrect, irrational and
2 materially misleading accounting practices.

3 **3. KPMG Failed to Adequately Plan its Audit**

4 207. Under GAAS, it is inherent in the planning process to have sufficient knowledge of
5 the Company, the industry, the environment, areas of audit exposure, weaknesses in internal control
6 and various other important matters in order to properly plan the audit. GAAS (AU § 311) states
7 that an auditor should:

- 8 i. Obtain a level of knowledge of the entity's business that will enable him to plan and
9 perform his audit in accordance with generally accepted auditing standards. That
10 level of knowledge should enable him to obtain an understanding of the events,
11 transactions, and practices that, in his judgment, may have a significant effect on the
12 Financial Statements. . . Knowledge of the entity's business helps the auditor in
13 identifying areas that may need special consideration;
- 14 ii. Assess conditions under which accounting data are produced, processed, reviewed,
15 and accumulated within the organization;
- 16 iii. Evaluate the reasonableness of estimates;
- 17 iv. Evaluate the reasonableness of management representations; and
- 18 v. Make judgments about the appropriateness of the accounting principles applied and
19 the adequacy of disclosures.

20 208. Moreover, the auditor is required to design the audit with professional skepticism
21 (AU § 230) in order to provide reasonable assurance of detecting errors, material misstatements
22 (AU § 312) or fraud (AU § 316).

23 209. KPMG failed to comply with GAAS as it failed to design its audit plan to provide
24 reasonable assurance of detecting material errors as required by AU § 312. KPMG was required
25 under GAAS to obtain knowledge of Brocade's business, to apply analytical procedures and to
26 assess the risk of material misstatement in planning for its audit.

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1 210. KPMG failed to consider and/or overlooked the existence of the red flags identified
2 herein, and other risk factors, and/or failed to properly design or modify its planned audit
3 procedures to mitigate those risks.

4 211. KPMG audited Brocade’s financial statements and provided tax, consulting, and
5 other services prior to and during the Class Period, for which it was paid handsomely, and had a
6 thorough knowledge of the Company’s financial history, accounting practices, internal controls, and
7 business operations. Despite this intimate familiarity with Brocade’s business practices, in auditing
8 Brocade’s Financial Statements, KPMG either knowingly or recklessly failed to:

- 9 i. Identify areas that needed special consideration (such as option grants and the utter
10 lack of internal controls) or identify such areas and audited them in a manner which
11 was so deficient that it amounted to no audit at all, while making audit judgments
12 that no reasonable auditor would have made if confronted with the same facts;
- 13 ii. Assess the conditions under which accounting data was produced, processed,
14 reviewed, and accumulated within the organization or assess such conditions and
15 made audit judgments based upon said assessment that no reasonable auditor would
16 have made if confronted with the same facts;
- 17 iii. Evaluate the reasonableness of estimates and management’s representations or
18 evaluated them in a manner which was so deficient that it amounted to no evaluation
19 at all; and
- 20 iv. Judge the appropriateness of the accounting principles applied and the adequacy of
21 disclosures in the Company’s Financial Statements or did so and arrived at
22 judgments that no reasonable auditor would have arrived at if confronted with the
23 same facts.

24 212. GAAS (AU § 311) states that audit planning involves developing an overall strategy
25 for the expected conduct and scope of the audit. Accordingly, GAAS recognizes that the nature,
26 extent, and timing of audit planning may vary with the size and complexity of the company,
27 experience with the company, and knowledge of the company’s business. In this regard, GAAS
28 (AU § 311) provides that in planning the audit, the auditor should prepare a written audit program
(or set of written audit programs) for every audit and that this audit program should set forth in
reasonable detail the audit procedures that the auditor believes are necessary to accomplish the
objectives of the audit. GAAS further states that, in developing the program, the auditor should be
guided by the results of the planning considerations and procedures and, as the audit progresses,

1 changed conditions may make it necessary to modify planned audit procedures. In preparing this
2 audit program, GAAS provides that the auditor should consider, among other things (AU § 311):

- 3 i. The entity's accounting policies and procedures;
- 4 ii. The methods used by the entity to process significant accounting information;
- 5 iii. Planned assessed level of control risk;
- 6 iv. Preliminary judgment about materiality levels for audit purposes;
- 7 v. Financial statement items likely to require adjustment; and
- 8 vi. Conditions that may require extension or modification of audit tests.

9 213. Had KPMG properly planned its audit, it would have identified areas in which
10 Brocade's internal control protocols were deficient and the areas of Brocade's accounting that were
11 subject to manipulation, and those areas where even basic accounting principles were not being
12 applied. KPMG's failure to adequately plan its audits under GAAS in order to assess the
13 materiality of ongoing repeated stock option grant transactions on Brocade's income or EPS, was
14 severely reckless and represented an extreme departure from the ordinary care required of an
15 auditor by AU § 230.

16 **4. Failure to Obtain Competent Evidential Matter**

17 214. KPMG violated Standard of Field Work No. 3, which requires sufficient competent
18 evidential matter to be obtained through inspection, observation, inquiries and confirmations to
19 afford a reasonable basis for an opinion regarding the Financial Statements under audit. GAAS
20 provides that accounting data alone is insufficient to support an opinion on financial statements.
21 Before rendering an opinion on financial statements, the auditor must obtain sufficient, competent
22 "evidential matter" to afford a reasonable basis for the opinion. "Evidential matter" consists of the
23 underlying accounting data and all corroborating information available to the auditor. (AU § 326).
24 Corroborating evidential matter includes both documentation obtained during the field work (e.g.,
25 checks, invoices, contracts, written plans and independent confirmations) and information obtained
26 from inquiry, observation, inspection and physical examination. (AU § 326).

27 215. Management's representations are not a valid substitute for the application of audit
28 procedures to form a reasonable basis for an auditor's opinion of financial statements (AU § 333).

1 Evidential matter that can be obtained from independent sources outside an entity provide greater
2 assurance of reliability than any internally developed. KPMG either complied with GAAS and sent
3 appropriate confirmations and knew and ignored that Brocade's financial statement assertions were
4 materially false and misleading, or it failed to comply with GAAS (AU § 330) and recklessly failed
5 to know.

6 216. In the course of auditing Brocade's Financial Statements during the relevant time
7 period, KPMG either knew or recklessly disregarded facts that indicated that it had failed to obtain
8 sufficient competent evidential matter to afford a reasonable basis for expressing unqualified
9 opinions on Brocade's Financial Statements. KPMG's staff was frequently present at Brocade's
10 offices and had access to Brocade's internal corporate books and records, particularly during its
11 annual audits. In addition, KPMG's staff had access to Brocade's private and confidential financial,
12 stock and business information. Given the availability of such records and information, KPMG
13 either obtained, through inspection, observations, inquiries, and other audit procedures, sufficient
14 competent evidential matter to compel it to issue qualified or adverse opinions on Brocade's
15 financial statements, or it recklessly failed to utilize the available records and information in the
16 performance of its audits and recklessly failed to issue qualified or adverse opinions on Brocade's
17 financial statements.

18 217. GAAS (AU § 326) notes that underlying accounting data and all corroborating
19 information available to the auditor (including books of original entry, the general and subsidiary
20 ledgers, related accounting manuals, and records such as work sheets and spreadsheets supporting
21 cost allocations, computations, checks, purchase orders, bills of lading, invoices, records of
22 electronic fund transfers, invoices, contracts, grants, stock plans, stock ledgers, minutes of meetings,
23 and reconciliations) constitute evidence that should be subjected to inquiry, observation, inspection,
24 confirmation, and physical examination during an audit. It is inconceivable that KPMG could have
25 inquired about, observed, inspected, confirmed and physically examined the available
26 documentation and failed to detect Brocade's fraudulent activities and the associated concealment
27 actions undertaken by the Company's management. Accordingly, KPMG either performed audits
28 that were so deficient that they amounted to no audits at all, or it identified and ignored, or

1 recklessly failed to investigate, extremely questionable transactions and documents, and made audit
2 judgments that no reasonable auditor would have made if confronted with the same facts.

3 218. Indeed, had KPMG reviewed Brocade's stock option plans, qualified and
4 unqualified, records of stock option grants made and exercised, and the stock ledger, all of which
5 are basic corporate documents, it could not have failed to notice and question the improper
6 accounting for grants and the failure to properly expense the same.

7 VII. LOSS CAUSATION

8 219. As detailed herein, throughout the Class Period, Defendants engaged in a scheme to
9 deceive the market and a course of conduct that artificially inflated the price of Brocade common
10 stock. Defendants achieved this facade of success and expected continued growth in part by
11 misrepresenting the Company's Financial Statements and reported earnings, as well as issuing
12 misleading statements concerning Brocade's ability to lure new hires in the competitive computing
13 industry. When Defendants' prior misrepresentations and fraudulent conduct were slowly revealed
14 and digested by the market, the price of Brocade common stock fell significantly, as the artificial
15 inflation was removed from the Company's stock price. As a result of their purchases of Brocade
16 common stock during the Class Period, Lead Plaintiff and other members of the Class suffered
17 economic loss, *i.e.*, damages, under the federal securities laws.

18 220. As set forth in detail above, Defendants continuously misrepresented the Company's
19 results of operations throughout the Class Period. On the day prior to the start of the Class Period,
20 on May 18, 2000, Brocade common stock traded at a price of \$58.81⁴ per share. During the Class
21 Period, due in part to Defendants' false and misleading misrepresentations and omissions, Brocade
22 common stock reached as high as the artificially inflated price of \$128.25 per share.

23 221. Defendants' scheme began to unravel on or about January 6, 2005. After the close of
24 the market on that date, Brocade publicly disclosed for the first time that "the way in which it

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26 ⁴ On May 18, 2000, Brocade common stock traded at a price of \$117.62 per share. However, the
27 stock price does not take into account the 2:1 stock split that occurred on December 22, 2000.
28 Thus, the adjusted stock price is \$58.81 per share. All references to stock prices will refer to the
adjusted price taking into account the December 22, 2000 2:1 stock split.

1 accounted for stock option grants was incorrect and requires restatement.” Specifically, Brocade
2 admitted that it incorrectly accounted for, and would record historical stock-based compensation
3 charges relating to, (i) grants that were made to new hires on their offer acceptance date, rather than
4 the date of their commencement of employment, during the period of May 1999 to July 2000, and
5 (ii) grants that were made to persons engaged on a part-time basis prior to their new hire full-time
6 employment during the period of August 2000 to October 2002. In light of these events, Brocade
7 stated that it expected to restate its Financial Statements for fiscal years ending 2002 and 2003 to
8 record additional stock-based compensation expense.

9 222. The shocking January 6, 2005 disclosure immediately removed part of the artificial
10 inflation from the price of Brocade common stock. In reaction to the announcement, Brocade
11 common stock fell from \$6.92 per share to \$6.40 per share in one trading day, representing a 7.5
12 percent drop. Volume in Brocade common stock exceeded 24 million shares on January 7, 2005,
13 compared to volumes of 8.8 million shares, 6.2 million shares, 7.6 million shares, 5.8 million
14 shares, and 2.3 million shares during the five previous trading days, respectively.

15 223. On April 28, 2005, amidst the SEC’s investigation of Brocade, analysts first began to
16 downgrade shares of Brocade from “buy” to “sell” and warn the public that Brocade would not be
17 able to meet its second quarter expectations. In reaction to analysts lowering their guidance,
18 Brocade common stock fell from \$5.04 per share on April 29, 2005 to as low as \$4.26 to close at
19 \$4.57 per share on April 28, 2005, representing a 9 percent drop on unusually high trading volume.

20 224. The artificial inflation contained in Brocade’s common stock price continued to
21 dissipate through Defendants’ further disclosure of wrongdoing at Brocade on May 16, 2005. In
22 addition to the improper accounting practices revealed on January 6, 2005, Brocade admitted that,
23 “from 2001 through 2004, the Company had not properly accounted for the cost of stock based
24 compensation for certain employees on leaves of absences (LOA) and in transition roles prior to
25 ceasing employment with Brocade.” All told, Defendants disclosed that the prior accounting
26 manipulations would force Brocade to restate its results of operations for fiscal years 2001 through
27 2004 as follows:

28

<u>Fiscal Year Ending</u>	<u>Additional Non-Cash Expense</u>	<u>Reduction in EPS</u>
2001	\$12.0 to \$26.0 million	\$0.05 to \$0.11
2002	\$19.0 to \$23.0 million	\$0.08 to \$0.09
2003	\$0.2 to \$0.8 million	\$0.00 to \$0.01
2004	\$0.8 to \$2.8 million	\$0.00 to \$0.01

225. In addition to the details concerning the Restatement and accounting improprieties, Brocade disclosed on May 16, 2005, that the Department of Justice was working with the SEC in a “joint investigation regarding the Company’s stock option granting practices.”

226. After the May 16, 2005 press release, the artificial inflation in the price of Brocade common stock was removed. By the time the market had completely digested the disclosure of the Company’s fraudulent accounting practices, the price of Brocade common stock fell to as low as \$3.77 per share on May 23, 2005.

227. As a direct result of Defendants' admissions and the public revelations regarding the truth about Brocade's previous representations and its actual business prospects going forward, Brocade's stock price plummeted 46%, falling from approximately \$6.92 in early January 2005 to as low as \$3.77 per share on May 23, 2005, a drop of \$3.15 per share. This drop removed the inflation from Brocade's stock price causing real economic loss to investors who had purchased the stock during the Class Period. In sum, as the truth about defendants' fraud and Brocade's business performance was revealed, the Company's stock price plummeted, the artificial inflation came out of the stock and plaintiff and other members of the Class were damaged, suffering economic losses of over 46% as evidenced by the drop in price of over \$3.00 per share.

228. The 46% decline in Brocade's stock price by the end of the Class Period was a direct result of the nature and extent of Defendants' fraud finally being revealed to investors and the market. The timing and magnitude of Brocade's stock price declines negate any inference that the loss suffered by Lead Plaintiff and other Class members was caused by changed market conditions, macroeconomic or industry factors or Company-specific facts unrelated to the Defendants' fraudulent conduct. During the same period in which Brocade's stock price fell 46% as a result of defendants' fraud being revealed, the Standard & Poor's 500 securities index was flat. The economic loss, *i.e.*, damages, suffered by plaintiff and other members of the Class was a direct

1 result of: (1) Defendants' fraudulent scheme to artificially inflate Brocade's stock price; and (2) the
2 subsequent significant decline in the value of Brocade's stock when Defendants' prior
3 misrepresentations and other fraudulent conduct were belatedly revealed.

4 **VIII. DEFENDANTS' FALSE AND MISLEADING STATEMENTS**

5 229. In light of the detailed facts set forth above, Defendants' regular press releases, made
6 by Brocade and Reyes, and Financial Statements filed with the SEC, which were made by Brocade
7 and signed by the Officer Defendants and Audit Committee Defendants, and audited by KPMG
8 (2002-2004), were material false and misleading statements during the Class Period. Set forth
9 chronologically below, these statements misrepresented Brocade's financial results because they
10 omitted information which would have shown that the Company's earnings per share, net income,
11 net stock compensation expenses and associated income tax consequences were far worse than what
12 the Company claimed in each of these statements. Additionally, these statements provided wholly
13 false explanations to support the Company's improperly reported results, and failed to disclose that
14 Brocade was engaging in a pervasive scheme and set of fraudulent accounting practices that
15 rendered its financial reporting wholly unreliable. Moreover, as the Class Period progressed,
16 Brocade was forced to live with the consequences of its earlier lies, the same accounting tricks on
17 which Brocade relied to boost its early Class Period results unwound and caused its later Class
18 Period results to suffer.

19 **A. 2000-2001**

20 230. On June 13, 2000, the Company filed its SEC Form 10-Q for the second quarter of
21 the year 2000.

22 231. On September 12, 2000, the Company filed its SEC Form 10-Q for the third quarter
23 of the year 2000.

24 232. On January 26, 2001, the Company filed its SEC Form 10-K for the year ended
25 2000.

26 233. On February 21, 2001, the Company issued a press release entitled "Brocade
27 Announces Record Revenue and Earnings for First Quarter of Fiscal 2001." The press release stated
28 in part:

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Brocade Communications Systems, Inc., the leading provider of Storage Area Networking infrastructure, reported today record revenue and earnings for the first quarter of fiscal 2001 (Q1 01). For Q1 01, net revenues were \$165.0 million, as compared to the \$42.7 million reported in the first quarter of fiscal 2000 (Q1 00) and the \$132.1 million reported in the fourth quarter of fiscal 2000 (Q4 00). During Q1 01, deferred revenue increased by \$7.1 million to \$9.1 million.

Net income for Q1 01 was \$32.5 million as compared to the \$7.3 million reported in Q1 00 and the \$27.2 million reported in Q4 00. Diluted net income per share for Q 1 01 was \$0.13 as compared to the \$0.03 reported in Q 1 00 and the \$0.11 reported in Q4 00.

Operating income as a percentage of net revenues in Q 1 01 increased to 26.9 percent of revenues, up from 26.6 percent in Q4 00. This is the seventh consecutive quarter that operating income, as a percentage of revenues, has increased.

* * *

Greg Reyes, Brocade President and CEO, commented on the quarter: "We are very pleased with our financial results for the quarter, which demonstrate our continued focus and execution in providing the world's leading networking infrastructure for storage area networks. In every industry, in every sector across the globe, companies are relying on Brocade SAN infrastructure to network their servers and storage, keep pace with exponential growth in data storage requirements, and deliver a platform to reduce the cost of managing, administering, and moving business-critical data."

234. On April 20, 2001, the Company issued a press release entitled "Brocade Announces Preliminary Q2 01 Financial Results." The press release stated in part:

Brocade Communications Systems, Inc. announced today preliminary results for the second quarter of fiscal 2001. Brocade expects to report total net revenue for the second quarter of fiscal 2001 (Q2 01) that will be approximately 30 percent less than the net revenue reported in the first quarter of fiscal 2001 (Q1 01). Diluted net income per share for Q2 01 is expected to be in the range of \$0.05-\$0.06 per share. During the second quarter, Brocade expects that gross margins will remain in the 60 percent range and will continue at those levels for the next several quarters. Additionally, Brocade expects that DSOs will be within the target range of 50 to 60 days.

"As enterprise capital spending continues to thaw, we are well positioned for growth in the latter part of fiscal 2001 and we expect our year-over-year revenue growth will be approximately 58 percent," said Greg Reyes, Brocade President and CEO.

1 235. On May 15, 2001, the Company issued a press release entitled "Brocade Announces
2 Second Quarter Fiscal 2001 Financial Results." The press release stated in part:

3 Brocade Communications Systems, Inc. reported today
4 financial results for the second quarter of fiscal 2001 (Q201). For Q2
5 01, net revenues were \$115.2 million as compared to the \$62.1
6 million reported in the second quarter of fiscal 2000 (Q200).

7 Net income for Q2 01 was \$12.0 million as compared to the
8 \$13.3 million reported in Q2 00. Diluted net income per share for Q2
9 01 was \$0.05 as compared to the \$0.06 reported in Q2 00. During the
10 second quarter, gross margins remained at 60 percent.

11 In Q2 01, Brocade generated \$6.1 million in cash after
12 purchasing \$16.9 million in capital equipment and making \$10.6
13 million in minority investments. Total cash at the end of Q2 01 was
14 \$217.1 million. Brocade exited the quarter with \$5.7 million in
15 deferred revenue. The majority of the deferred revenue was related to
16 inventory held by Brocade master resellers that has not sold through
17 to the end customer.

18 Greg Reyes, Brocade Chairman and CEO, commented on the quarter:

19 Considering the current difficult economic environment for
20 technology companies, the second quarter was a period of significant
21 achievement for Brocade. We are pleased that we met the
22 expectations that we set out in April, and we believe that the second
23 quarter was the low water mark for our business.

24 236. On August 15, 2001, the Company issued a press release entitled "Brocade Exceeds
25 Revenue Estimates for the Third Quarter of Fiscal 2001." The press release stated in part:

26 Brocade Communications Systems, Inc. reported today
27 financial results for the third quarter of fiscal 2001 (Q3 01). For Q3
28 01, net revenues were \$116.3 million, a \$24.2 million increase from
the \$92.1 million reported in the third quarter of fiscal 2000 (Q3 00)
and a \$1.1 million increase from the second quarter of fiscal 2001
(Q201). Brocade exited the quarter with \$13.4 million in deferred
revenue, an increase of \$7.7 million over the \$5.7 million reported in
Q2 01.

Net income for Q3 01 was \$12.0 million as compared to the
\$20.1 million reported in Q3 00 and the \$12.0 million reported in Q2
01. Diluted net income per share for Q3 01 was \$0.05 as compared to
the \$0.08 reported in Q3 00 and the \$0.05 reported in Q2 01. During
the third quarter, gross margins remained at 60 percent, an
improvement over the 58.6 percent reported in Q3 00 and consistent
with Q2 01. In Q3 01, Brocade generated \$23.8 million in cash after
investing \$20.6 million in capital equipment. Total cash at the end
of Q3 01 was \$241.0 million.

1 Greg Reyes, Brocade Chairman and CEO, commented on the
2 quarter: "We are pleased with our results for the third quarter, which
3 demonstrate our ability to manage well through a challenging
4 economic environment.

5 237. On November 28, 2001, the Company issued a press release entitled "Brocade
6 Announces Record Revenue for Fiscal Year 2001; Storage Networking Leader Reports Annual
7 Revenue Growth of 56 Percent." The press release stated in part:

8 Brocade Communications Systems, Inc. reported today
9 financial results for the fourth quarter ended October 27, 2001 (Q401).
10 In Q4 01, net revenue was \$116.5 million, as compared to the \$116.3
11 million reported in the third quarter of fiscal 2001 (Q301). For fiscal
12 year 2001 (FY 01), revenue was a record \$513.0 million, an increase
13 of \$184.0 million, or 56 percent, from fiscal year 2000 (FY 00).
14 Brocade exited Q401 with \$12.6 million in deferred revenue.

15 Diluted pro forma net income per share for Q4 01 was \$0.05,
16 consistent with the diluted net income per share reported in Q3 01.
17 Pro forma net income for Q4 01 was \$10.9 million as compared to net
18 income of \$12.0 million reported in Q3 01. For FY 01, pro forma net
19 income was \$67.4 million and pro forma diluted net income per share
20 was \$0.28, as compared to net income of \$67.9 million and diluted net
21 income per share of \$0.28, respectively, reported in FY 00. These pro
22 forma results exclude charges of \$77.1 million related to purchase
23 commitments, facilities lease losses and asset impairments, and the
24 write-down of private minority equity investments.

25 These results compare to net revenue of \$132.1 million
26 reported in the fourth quarter of fiscal 2000 (Q4 00) and net income
27 and diluted net income per share of \$27.2 million and \$0.11,
28 respectively.

During the fourth quarter, pro forma gross margins remained
at 60.0 percent, a slight improvement over the 59.8 percent gross
margins reported in Q4 00 and consistent with Q3 01 gross margins.
Gross margins on a pro forma basis for FY 01 were 60.0 percent, as
compared to 58.2 percent gross margins for FY 00.

In Q4 01 Brocade generated \$14.2 million in cash after
purchasing approximately \$18.7 million in capital equipment. For FY
01, Brocade generated more than \$100 million in cash, after investing
\$82.3 million in capital equipment. Brocade's total cash balance at the
end of Q4 01 was a record \$255.1 million.

For Q4 01, accounts receivable days sales outstanding was 54
days, down from the 57 days achieved during Q3 01. Inventory at the
end of the fourth quarter was \$10.3 million and represented
annualized inventory turns of 18 times on a pro forma basis.

1 Greg Reyes, Brocade Chairman and CEO, commented on the
 2 quarter, "We are very pleased with our results for 2001 and our ability
 3 to manage and optimize our business model in a challenging
 4 economic environment. We believe that our investments in 2001,
 including our significant investment in research and development,
 will allow us to take full advantage of the next phase in the market's
 evolution and position us for resumed growth in 2002."

5 238. The above false and misleading financial data also was included in the following
 6 Financial Statements filed by Brocade with the SEC and were signed by the following Defendants:

7	<u>Date of Filing</u>	<u>Name of Filing</u>	<u>Signed by</u>
8	June 13, 2000	2Q 2000 10-Q	Defendant Byrd
9	September 12, 2000	3Q 2000 10-Q	Defendant Byrd
10	January 26, 2001	10-K	Defendants Byrd, Reyes, Neiman, Dempsey, Leslie, Sonsini
11	March 13, 2001	1Q 2001 10-Q	Defendant Byrd
12	June 12, 2001	2Q 2001 10-Q	Defendant Canova
13	September 11, 2001	3Q 2001 10-Q	Defendant Canova

14 239. Each of the above-listed press releases and Financial Statements were false and
 15 misleading for the reasons set forth in Section VI, *supra*, because, *inter alia*, each such statement
 16 overstated Brocade's earnings per share and net income, and understated Brocade's compensation
 expenses and related tax expenses.

17 **B. 2002**

18 240. On January 24, 2002, the Company filed its SEC Form 10-K for the year ended
 19 2001.

20 241. On February 13, 2002, the Company issued a press release entitled "Brocade Reports
 21 Financial Results for the First Quarter of Fiscal Year 2002." The press release stated in part:

22 Brocade Communications Systems, Inc. reported today
 23 financial results for the first fiscal quarter of 2002 (Q1 02), which
 ended January 26, 2002. In Q1 02, net revenue was \$123.1 million,
 24 gross margins were 60 percent, net income was \$11.7 million, and
 diluted net income per share was \$0.05. Quarterly sequential revenue
 25 growth for Q1 02 was nearly six percent.

26 Brocade exited Q1 02 with \$13.9 million in deferred revenue,
 27 an increase of \$1.3 million over deferred revenue at the end of the
 fourth fiscal quarter of 2001 (Q4 01).

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In Q1 02 Brocade generated \$568.7 million in cash including \$537.6 million received from the issuance of convertible subordinated debt. Excluding the net proceeds from the convertible debt offering, cash increased \$31.1 million after purchasing \$24.5 million in capital equipment. Brocade's total cash, cash equivalents and short-term investments were \$823.9 million at the end of Q1 02.

For Q1 02, accounts receivable days sales outstanding were 54 days, consistent with Q4 01. Inventory at the end of Q1 02 was \$9.2 million, down from the \$10.3 million at the end of Q4 01.

Greg Reyes, Brocade Chairman and CEO, commented on the quarter, "We are extremely pleased with our results for the first fiscal quarter of 2002.

242. On May 15, 2002, the Company issued a press release entitled "Brocade Reports Financial Results for the Second Fiscal Quarter of 2002; And More Than 9 Percent Quarterly Sequential Revenue Growth." The press release stated in part:

Brocade Communications Systems, Inc. reported today financial results for the second fiscal quarter ended April 27, 2002 (Q2 02). In Q2 02, net revenues were \$135.0 million, which is an increase of more than 17 percent from the \$115.2 million reported in the second fiscal quarter of 2001 (Q2 01), and an increase of more than 9 percent from the \$123.1 million reported in the first fiscal quarter of 2002 (Q1 02). Brocade exited Q2 02 with \$16.1 million in deferred revenue, which is an increase of \$2.2 million from Q1 02.

Net income for Q2 02 was \$14.0 million, which is an increase of nearly 17 percent from the \$12.0 million reported in Q2 01 and a nearly 20 percent increase from the \$11.7 million reported in Q1 02. Diluted net income per share for Q2 02 was \$0.06, an increase from the \$0.05 reported in Q1 02 and \$0.05 for Q2 01. During Q2 02, gross margins were 60.2 percent.

In Q2 02 cash and investments increased by \$23.8 million, after purchasing approximately \$17.8 million in capital equipment. Total cash and investments at the end of Q2 02 were a record \$847.7 million. For Q2 02, accounts receivable days sales outstanding were 53 days, an improvement of 1 day over that reported in Q102. Inventory at the end of Q2 02 was \$5.5 million.

Greg Reyes, Brocade Chairman and CEO, commented on the quarter, "We are extremely pleased with our results for the second fiscal quarter of 2002."

1 243. On November 21, 2002, the Company issued a press release entitled "Brocade
 2 Announces Q4 and Fiscal 2002 Financial Results; Storage Networking Leader Achieves 31 Percent
 3 Year over Year Revenue Growth in Q4 02; Reports Record Revenue for Fiscal 2002 of \$562.4
 4 Million." The press release stated in part:

5 Brocade Communications Systems, Inc. announced today
 6 financial results for its fourth quarter ended October 26, 2002 (Q4 02).
 7 For Q4 02, net revenue was \$153.1 million, an increase of 31 percent
 8 from \$116.5 million reported in the fourth quarter of fiscal 2001
 9 (Q401). This compares to \$151.2 million reported in the third quarter
 of fiscal 2002 (Q3 02). For fiscal 2002 (FY 02), revenue was a record
 \$562.4 million, an increase of 10 percent from \$513.0 million
 reported in fiscal 2001 (FY01).

10 Net income for Q4 02 was \$15.7 million, or \$0.07 per share.
 11 This compares to a net loss of \$53.7 million for Q4 01 or \$0.24 per
 12 share. For FY 02, net income was \$59.7 million or \$0.25 per share, as
 compared to net income of \$2.8 million or \$0.01 per share, reported in
 FY 01.

13 Deferred revenue at the end of Q4 02 was \$22.4 million, an
 14 increase of \$4.1 million from \$18.3 million at the end of Q3 02.
 During Q4 02, gross margins were 58.5 percent.

15 244. The above false and misleading statements were also made in the following
 16 Financial Statements filed by Brocade with the SEC and were signed by the following Defendants:

<u>Date of Filing</u>	<u>Name of Filing</u>	<u>Signed by</u>
18 June 24, 2002	2001 10-K	Defendants Reyes, Canova, Dempsey, Leslie, Neiman, Sonsini
19 March 12, 2002	1Q 2002 10-Q	Defendant Canova
20 May 30, 2002	2Q 2002 10-Q	Defendant Canova
21 August 27, 2002	3Q 2002 10-Q	Defendants Canova & Reyes

22 245. Each of the above-listed press releases and Financial Statements were false and
 23 misleading for the reasons set forth in Section VI, *supra*, because, *inter alia*, each such statement
 24 overstated Brocade's earnings per share and net income, and understated Brocade's compensation
 25 expenses and related tax expenses.

26 **C. 2003**

27 246. On January 22, 2003, the Company filed its SEC Form 10-K for the fiscal year ended
 28 2002.

1 247. On February 12, 2003, the Company issued a press release entitled "Brocade Reports
2 Financial Results for the First Quarter of Fiscal 2003; Storage Networking Leader Achieves
3 Business Optimization Targets and Expands Market Leadership Position." The press release stated
4 in part:

5 Brocade Communications Systems, Inc. reported financial
6 results today for its quarter of fiscal year 2003 ended January 25, 2003
7 (Q1 03). Net revenue for Q1 03 was first \$123.1 million. This
8 compares to \$153.1 million reported in the fourth quarter of fiscal
9 year 2002 (Q4 02), and \$123.1 million reported in the first quarter of
10 fiscal year 2002 (Q1 02).

11 Pro forma net income for Q1 03 was \$0.3 million or \$0.00 per
12 share. Pro forma net income excludes a restructuring charge of \$10.1
13 million associated with the 12 percent reduction in workforce that was
14 announced on November 21, 2002. Reporting on a Generally
15 Accepted Accounting Principles (GAAP) basis, net loss for Q1 03 was
16 \$6.9 million, or \$0.03 per share. This compares to GAAP net income
17 for Q4 02 of \$15.7 million, or \$0.07 per share, and GAAP net income
18 of \$11.7 million or \$0.05 per share in Q1 02. A reconciliation
19 between pro forma net income and net loss on a GAAP basis is
20 provided in a table summary immediately following the Pro Forma
21 Condensed Consolidated Statements of Operations.

22 Greg Reyes, Brocade Chairman and CEO, commented on the
23 quarter, "We are pleased with our financial results for the first quarter
24 of fiscal year 2003. This was a quarter of continued execution for
25 Brocade. We met our business optimization goals, reducing operating
26 expenses by 12 percent quarter over quarter

27 248. On May 14, 2003, the Company issued a press release entitled "Brocade Reports
28 Second Quarter Fiscal 2003 Financial Results." The press release stated in part:

 Brocade Communications Systems, Inc. reported today
financial results for its second quarter of fiscal year 2003, which
ended April 26, 2003 (Q2 03). Net revenue for Q2 03 was \$130.9
million, which compares to \$123.1 million reported in the first quarter
of fiscal year 2003 (Q1 03), and \$135.0 million reported in the second
quarter of fiscal year 2002 (Q2 02).

 Reporting on a Generally Accepted Accounting Principles
(GAAP) basis, net loss for Q2 03 was \$146.0 million, or \$0.57 per
share. This compares to a GAAP net loss for Q1 03 of \$6.9 million, or
\$0.03 per share, and GAAP net income of \$14.0 million or \$0.06 per
share in Q2 02.

1 Non-GAAP net loss for Q2 03 was \$1.0 million or \$0.00 per
2 share, as compared to non-GAAP net income of \$0.3 million or \$0.00
3 per share in Q1 03. There was no difference between GAAP and non-
4 GAAP net income in Q2 02. Non- GAAP net income for Q2 03
5 excludes in-process research and development, deferred stock
6 compensation and other acquisition costs related to the acquisition of
7 Rhapsody Networks, Inc. (Rhapsody) in Q2 03, and severance, asset
8 impairment, and other charges related to the restructuring of business
9 operations that was announced on April 10, 2003. A reconciliation
10 between GAAP and non-GAAP information is attached to this press
11 release.

12 "I am pleased with the results that we have delivered in
13 meeting our expectations of revenue, gross margin and operating
14 expense," said Greg Reyes, Brocade Chairman and CEO. "Moving
15 forward, we remain committed to driving revenue growth and
16 profitability."

17 249. On August 13, 2003, the Company issued a press release entitled "Brocade Reports
18 Third Quarter Fiscal 2003 Financial Results; Storage Networking Leader Increases Revenue, Net
19 Income, and EPS On a Sequential Basis." The press release stated in part:

20 Brocade Communications Systems, Inc. reported today
21 financial results for its third quarter of fiscal year 2003 (Q3 03),
22 which ended July 26, 2003. Net revenue for Q3 03 was \$133.5 million,
23 an increase from the \$130.9 million reported in the second quarter of
24 fiscal year 2003 (Q203). Net revenue reported in the third quarter of
25 fiscal year 2002 (Q3 02) was \$151.2 million.

26 Non-GAAP net income for Q3 03 was \$2.0 million, or \$0.01
27 per share, as compared to anon-GAAP net loss of \$1.0 million or
28 \$0.00 per share in Q2 03. Non- GAAP net income for Q3 03 excludes
deferred stock compensation related to the acquisition of Rhapsody
Networks, Inc. (Rhapsody) that was completed in Q2 03. A
reconciliation between GAAP and non-GAAP information is
contained in the tables below.

Reporting on a Generally Accepted Accounting Principles
(GAAP) basis, net income for Q3 03 was \$1.9 million, or \$0.01 per
share. This compares to a GAAP net loss for Q2 03 of \$146.0 million,
or \$0.57 per share, and GAAP net income of \$18.3 million or \$0.08
per share in Q3 02. There was no difference between GAAP and non-
GAAP net income in Q3 02.

We are pleased with our results for our third fiscal quarter in
which we delivered increased revenue, operating income, and
earnings per share to our shareholders," said Greg Reyes, Brocade
Chairman and CEO.

1 250. On November 20, 2003, the Company issued a press release entitled "Brocade
2 Reports Fourth Quarter and Fiscal Year 2003 Results; Storage Networking Leader Increases
3 Revenue, Net Income, and EPS on a Sequential Basis." The press release stated in part:

4
5 Brocade Communications Systems, Inc. reported today
6 financial results for its fourth quarter (Q4 03) and fiscal year 2003
7 (FY 03) which ended October 25, 2003. Net revenue for Q4 03 was
8 \$137.8 million, an increase of three percent from \$133.5 million
9 reported in the third quarter of fiscal year 2003 (Q3 03). Net revenue
reported in the fourth quarter of fiscal year 2002 (Q4 02) was \$153.1
million. Net revenue for FY 03 was \$525.3 million, as compared to
net revenue of \$562.4 million reported in fiscal year 2002 (FY 02).

10 Non-GAAP net income for Q4 03 was \$4.6 million, or \$0.02
11 per share, as compared to anon-GAAP net income of \$2.0 million, or
12 \$0.01 per share, in Q3 03. Non-GAAP net income for Q4 03 excludes
13 gains related to repurchases of convertible subordinated debt, a gain
14 on the disposition of private strategic investments, a reduction of
15 previously recorded restructuring costs, and deferred stock
16 compensation expense related to the acquisition of Rhapsody
Networks, Inc. For FY 03, non-GAAP net income was \$5.6 million,
or \$0.02 per share. Non-GAAP net income for FY 03 excludes gains
related to repurchases of convertible subordinated debt, net gains on
the disposition of private strategic investments, restructuring costs,
and deferred stock compensation and in-process research and
development expenses related to the Rhapsody acquisition.

17 251. The above false and misleading statements were also made in the following
18 Financial Statements filed by Brocade with the SEC and were signed by the following Defendants:

<u>Date of Filing</u>	<u>Name of Filing</u>	<u>Signed by</u>
January 22, 2003	2002 10-K	Defendants Reyes, Canova, Dempsey, Neiman, Paisley and Sonsini
March 7, 2003	1Q 2003 10-Q	Defendants Canova & Reyes
June 9, 2003	2Q 2003 10-Q	Defendants Canova & Reyes
September 8, 2003	3Q 2003 10-Q	Defendants Canova & Reyes

24 252. Each of the above-listed press releases and Financial Statements were false and
25 misleading for the reasons set forth in Section VI, *supra*, because, *inter alia*, each such statement
26 overstated Brocade's earnings per share and net income, and understated Brocade's compensation
27 expenses and related tax expenses.

28

1 **D. 2004**

2 253. On January 20, 2004, the Company filed its SEC Form 10-K for the year ended
3 2003.

4 254. On February 11, 2004, the Company issued a press release entitled "Brocade Reports
5 First Quarter of Fiscal 2004 Results; Revenues Increase 5% Sequentially and 18% Year Over
6 Year." The press release stated in part:

7 Brocade Communications Systems, Inc. reported today
8 financial results for its first quarter of fiscal year 2004 (Q1 04) which
9 ended January 24,2004. Net revenues for Q 1 04 were \$145.0 million,
10 an increase of five percent from \$137.8 million reported in the fourth
11 quarter of fiscal year 2003 (Q4 03) and an increase of 18 percent
12 from\$123.1 million reported in the first quarter of fiscal 2003 (Q1 03).

13 "Our first quarter was a good one, and fiscal 2004 is off to an
14 excellent start for Brocade. During the first quarter, we saw revenue
15 growth across our entire business," said Greg Reyes, Brocade
16 Chairman and CEO. "This represents our 4th quarter in a row of
17 improved revenue, gross margin and operating margin. With our
18 upcoming product cycle and improving trends in the storage sector,
19 we continue to be confident in our market position and future
20 prospects."

21 Non-GAAP net income for Q1 04 was \$8.0 million, or \$0.03
22 per share, as compared to non-GAAP net income of\$4.6 million, or
23 \$0.02 per share, reported in Q4 03 and non-GAAP net income of \$0.0
24 million, or \$0.00 per share, reported in Q 103. Non-GAAP net income
25 for Q1 04 excludes gains related to repurchases of convertible
26 subordinated debt, deferred stock compensation expense related to the
27 acquisition of Rhapsody Networks, Inc. (Rhapsody), and lease
28 termination, facilities consolidation and other related costs. Non-
GAAP net income for Q4 03 excludes gains related to repurchases of
convertible subordinated debt, a gain on the disposition of private
strategic investments, a reduction of previously recorded restructuring
costs, and deferred stock compensation expense related to the
acquisition of Rhapsody. Non-GAAP net income for Q1 03 excludes
net gains on the disposition of private strategic investments and
restructuring costs associated with a company-wide workforce
reduction in Q1 03. A reconciliation between GAAP and non-GAAP
information is contained in the tables below.

Reporting on a GAAP basis, net loss for Q1 04 was \$36.8
million, or \$(0.14) per share. This compares to GAAP net income for
Q4 03 of\$14.8 million, or \$0.06 per share, and GAAP net loss for Q1
03 of\$6.9 million, or \$(0.03) per share.

1 255. On May 19, 2004, the Company issued a press release entitled "Brocade Reports
2 Second Quarter of Fiscal 2004 Results; Revenues and Gross Margins Increase for Fifth Consecutive
3 Quarter." The press release stated in part:

4 Brocade Communications Systems, Inc. reported today
5 financial results for its second quarter of fiscal year 2004 (Q2 04)
6 which ended May 1, 2004. Net revenues for Q2 04 were \$145.6
7 million, a slight increase from \$145.0 million reported in the first
8 quarter of fiscal year 2004 (Q1 04) and an increase of 11 percent from
9 \$130.9 million reported in the second quarter of fiscal 2003 (Q203).

10 "In addition to delivering our fifth consecutive quarter of
11 improvement in revenue and gross margin, during the quarter we
12 continued to execute on our long term strategy by extending our
13 product portfolio with four major product introductions," said Greg
14 Reyes, Brocade Chairman and CEO. "We also strengthened the
15 company's position across the entire spectrum of the SAN market and
16 have set the stage to accelerate the achievement of our previously
17 stated financial model targets by a full year."

18 Non-GAAP net income for Q2 04 was \$8.1 million, or \$0.03
19 per share, as compared to non-GAAP net income of \$8.0 million, or
20 \$0.03 per share, reported in Q 1 04 and non-GAAP net loss of \$1.1
21 million, or \$(0.00) per share, reported in Q203. Non-GAAP net
22 income for Q2 04 excludes restructuring charges, settlement cost of a
23 claim associated with the acquisition of Rhapsody Networks, Inc.
24 (Rhapsody), deferred stock compensation expense related to
25 Rhapsody, and gains on the disposition of private strategic
26 investments. Non-GAAP net income for Q1 04 excludes lease
27 termination, facilities consolidation and other related costs, deferred
28 stock compensation expense related to the acquisition of Rhapsody,
and gains related to repurchases of convertible subordinated debt.
Non-GAAP net loss for Q2 03 excludes restructuring charges, in-
process research and development, and deferred stock compensation
expense related to the acquisition of Rhapsody, and gains related to
repurchases of convertible subordinated debt. Non-GAAP net loss for
Q2 03 excludes restructuring charges, in-process research and
development, and deferred stock compensation expense related to the
acquisition of Rhapsody. A reconciliation between GAAP and non-
GAAP net income (loss) is contained in the tables below.

Reporting on a GAAP basis, net loss for Q2 04 was \$2.0
million, or \$(0.01) per share. This compares to GAAP net loss for Q1
04 of \$36.8 million, or \$(0.14) per share, and GAAP net loss for Q2
03 of \$146.0 million, or \$(0.57) per share.

1 256. On August 12, 2004, the Company issued a press release entitled "Brocade
2 Announces Preliminary Q3 2004 Results; Revenue on Track, Exceeds EPS Guidance." The press
3 release stated in part:

4 Brocade Communications Systems, Inc., the world's leading
5 provider of infrastructure solutions for Storage Area Networks
6 (SANs), today announced preliminary results for the third quarter of
7 fiscal 2004 (Q3 04) ended July 31, 2004. Brocade expects to report
8 net revenue for Q3 04 in a range of \$149.5 to 150.5 million and GAAP
9 net income per share of \$0.06 to \$0.07. The GAAP earnings include a
10 pre-tax gain of \$3.5 million, equivalent to \$0.01 per share, related to
11 repurchases of \$47.4 million of the company's convertible
12 subordinated debt.

13 "I am pleased to announce revenue that is in line with our
14 previous outlook and better than expected EPS," said Greg Reyes,
15 Brocade Chairman and CEO. "Given the unusually large number of
16 pre-announcements by storage-related companies with lower than
17 expected financial results, we believe that it is important to provide
18 our preliminary results so the market can assess Brocade's
19 performance and competitive position accurately."

20 257. On November 22, 2004, the Company issued a press release entitled "Brocade
21 Reports Fourth Quarter and Fiscal Year 2004 Results; Record Annual Revenue of \$596.3 Million
22 Increases 14% Year Over Year Fourth Quarter Operating Margin Increases to 16%." The press
23 release stated in part:

24 Brocade Communications Systems, Inc. reported today
25 financial results for its fourth quarter (Q4 04) and fiscal year 2004
26 (FY 04) which ended October 30, 2004. Net revenues for Q4 04 were
27 \$155.6 million, an increase of four percent from \$150.0 million
28 reported in the third quarter of fiscal year 2004 (Q3 04) and an
increase of 13 percent from \$137.8 million reported in the fourth
quarter of fiscal 2003 (Q403). Net revenues for FY 04 were \$596.3
million, an increase of 14 percent from \$525.3 million reported in
fiscal year 2003 (FY 03)

 Non-GAAP net income for Q4 04 was \$18.6 million, or \$0.07
per share, as compared to non-GAAP net income of \$15.2 million, or
\$0.06 per share, reported in Q3 04 and non-GAAP net income of \$4.6
million, or \$0.02 per share, reported in Q4 03. Non-GAAP net income
for Q4 04 excludes deferred stock compensation expense related to
Rhapsody Networks, Inc. (Rhapsody), a reduction of previously
recorded restructuring costs, and gains related to repurchases of the
Company's convertible subordinated debt. Non-GAAP net income for
Q3 04 excludes deferred stock compensation expense related to the
acquisition of Rhapsody, gains related to repurchases of the
Company's convertible subordinated debt, and gains on the
disposition of private strategic investments. Non-GAAP net income
for Q4 03 excludes deferred stock compensation expense related to

1 the acquisition of Rhapsody, a reduction of previously recorded
 2 restructuring costs, gains related to repurchases of the Company's
 3 convertible subordinated debt, and gains on the disposition of private
 strategic investments. A reconciliation between GAAP and non-
 GAAP net income is contained in the tables below.

4 Reporting on a GAAP basis, net income for Q4 04 was \$20.4
 5 million, or \$0.08 per share basic and diluted. This compares to GAAP
 net income for Q3 04 of \$17.0 million, or \$0.06 per share diluted,
 6 \$0.07 per share basic, and GAAP net income for Q4 03 of \$14.8
 million, or \$0.06 per share basic and diluted.

7
 8 "Fiscal 2004 was a good year for Brocade and I am very proud
 of our results," said Greg Reyes, Brocade Chairman and CEO.
 9 "During the year we expanded and extended our product line,
 introduced new products in new segments, executed on our business
 10 strategy, achieved our financial model targets, and strengthened the
 overall position of the company."
 11

12 258. The following Financial Statements filed with the SEC also were materially false and
 13 misleading and omitted material facts because each 10-K and 10-Q contained the same financial
 14 data regarding Brocade's expenses, revenue, and earnings per share:

<u>Date of Filing</u>	<u>Name of Filing</u>	<u>Signed by</u>
16 January 20, 2004	2003 10-K	Defendants Reyes, Canova, Dempsey, Neiman, Paisley, Moore, Sonsini and KPMG
18 March 8, 2004	1Q 2004 10-Q	Defendants Canova & Reyes
June 14, 2004	2Q 2004 10-Q	Defendants Canova & Reyes
19 January 31, 2004	3Q 2004 10-Q	Defendants Canova Dempsey, Neiman, Paisley, Moore Sonsini and KPMG
21 March 9, 2005	1Q 2005 10-K	Defendant Canova

22 259. Each of the above-listed press releases and Financial Statements were false and
 23 misleading for the reasons set forth in Section VI, supra, because, inter alia, each such statement
 24 overstated Brocade's earnings per share and net income, and understated Brocade's compensation
 25 expenses and related tax expenses.

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IX. CLASS ACTION ALLEGATIONS

260. Lead Plaintiff brings this action as a class action pursuant to Federal Rule of Civil Procedure 23(a) and (b)(3) on behalf of a class consisting of all those who purchased the securities of Brocade between May 18, 2000 and May 15, 2005, inclusive, and who were damaged thereby (the "Class"). Excluded from the Class are Defendants, the officers and directors of the Company, at all relevant times, members of their immediate families and their legal representatives, heirs, successors or assigns and any entity in which Defendants have or had a controlling interest.

261. The members of the Class are so numerous that joinder of all members is impracticable. Throughout the Class Period, Brocade stock was actively traded on the NASDAQ. While the exact number of Class members is unknown to Lead Plaintiff at this time and can only be ascertained through appropriate discovery, Lead Plaintiff believes that there are hundreds or thousands of members in the proposed Class. Record owners and other members of the Class may be identified from records maintained by Brocade or its transfer agent and may be notified of the pendency of this action by mail, using the form of notice similar to that customarily used in securities class actions.

262. Lead Plaintiff's claims are typical of the claims of the members of the Class as all members of the Class are similarly affected by Defendants' wrongful conduct in violation of federal law complained of herein.

263. Lead Plaintiff will fairly and adequately protect the interests of the members of the Class and has retained counsel competent and experienced in class and securities litigation.

264. Common questions of law and fact exist as to all members of the Class and predominate over any questions solely affecting individual members of the Class. Among the questions of law and fact common to the Class are:

- (a) whether the federal securities laws were violated by Defendants' acts as alleged herein;
- (b) whether statements made by Defendants to the investing public during the Class Period misrepresented material facts about the business and operations of Brocade;

1 (c) whether the prices of Brocade's publicly traded securities were artificially inflated
2 during the Class Period; and

3 (d) to what extent the members of the Class have sustained damages and the proper
4 measure of damages.

5 265. A class action is superior to all other available methods for the fair and efficient
6 adjudication of this controversy since joinder of all members is impracticable. Furthermore, as the
7 damages suffered by individual Class members may be relatively small, the expense and burden of
8 individual litigation make it impossible for members of the Class to individually redress the wrongs
9 done to them. There will be no difficulty in the management of this action as a class action.

10 **X. LEAD PLAINTIFF IS ENTITLED TO A PRESUMPTION OF RELIANCE FOR**
11 **DEFENDANTS' OMISSIONS OF MATERIAL FACTS UNDER THE AFFILIATED UTE**
12 **DOCTRINE, AND/OR, IN THE ALTERNATIVE, UNDER THE FRAUD ON THE**
13 **MARKET DOCTRINE**

14 266. Lead Plaintiff is entitled to a presumption of reliance under *Affiliated Ute v. United*
15 *States*, 406 U.S. 128 (1972) because the claims asserted herein against Defendants are primarily
16 predicated upon omissions of material fact of which there was a duty to disclose.

17 267. In the alternative, Lead Plaintiff is entitled to a presumption of reliance under the
18 fraud on the market doctrine on Defendants' material misrepresentations and omissions for the
19 following reasons:

- 20 i. Brocade's publicly-traded securities were actively traded in an efficient market on
21 the NASDAQ during the period in which Lead Plaintiff bought and/or sold Brocade
22 securities;
- 23 ii. As a regulated issuer, Brocade filed periodic public reports with the SEC;
- 24 iii. Brocade regularly communicated with public investors via established market
25 communication mechanisms, including through regular disseminations of press
26 releases on the major news wire services and through other wide-ranging public
27 disclosures, such as communications with the financial press, securities analysts and
28 other similar reporting services;
- iv. The market reacted to public information disseminated by Brocade;

1 v. Brocade was followed by numerous securities analysts employed by major brokerage
2 firms who wrote reports which were distributed to the sales force and certain
3 customers of their respective firms. Each of these reports was publicly available and
4 entered the public marketplace;

5 vi. The material misrepresentations and omissions alleged herein would tend to induce a
6 reasonable investor to misjudge the value of the Brocade's shares; and

7 vii. Without knowledge of the misrepresented or omitted material facts alleged herein,
8 Lead Plaintiff and other members of the Class purchased Brocade securities between
9 the time Defendants misrepresented or failed to disclose material facts and the time
10 the true facts were disclosed.

11 268. In addition to the foregoing, Lead Plaintiff is entitled to a presumption of reliance
12 because, as more fully alleged above, Defendants failed to disclose material information regarding
13 Brocade's business, financial results and business prospects, throughout the Class Period.

14 **XI. NO SAFE HARBOR**

15 269. As alleged herein, the Officer Defendants, the Audit Committee Defendants, and
16 KPMG acted with *scienter* in that they knew, at the time they issued them, that the public
17 documents and statements issued or disseminated in the name of Brocade were materially false and
18 misleading or omitted material facts; knew that such statements or documents would be issued or
19 disseminated to the investing public; knew that members of the investing public were likely to
20 reasonably rely on those misrepresentations and omissions; and knowingly and substantially
21 participated or were involved in the issuance or dissemination of such statements or documents as
22 primary violations of the federal securities law. As set forth elsewhere herein in detail, these
23 Defendants, by virtue of their receipt of information reflecting the true facts regarding Brocade,
24 their control over, and/or receipt of Brocade's allegedly materially misleading misstatements and/or
25 their association with the companies which made them privy to confidential proprietary information
26 concerning Brocade, which were used to inflate financial results and which the Defendants caused
27 or were informed of, participated in and knew of the fraudulent scheme alleged herein. With
28 respect to non-forward-looking statements and/or omissions, the Defendants knew and/or recklessly

1 disregarded the falsity and misleading nature of the information which they caused to be
2 disseminated to the investing public.

3 270. Defendants' false and misleading statements and omissions do not constitute
4 forward-looking statements protected by any statutory safe harbor. The statements alleged to be
5 false and misleading herein all relate to facts and conditions existing at the time the statements were
6 made. No statutory safe harbor applies to any of Brocade's material false or misleading statements.

7 271. Alternatively, to the extent that any statutory safe harbor is intended to apply to any
8 forward-looking statement pled herein, the Defendants are liable for the false forward-looking
9 statement pled because, at the time each forward-looking statement was made, the speaker knew or
10 had actual knowledge that the forward-looking statement was materially false or misleading, and
11 the forward-looking statement was authorized and/or approved by a director and/or executive
12 officer of Brocade who knew that the forward-looking statement was false or misleading. None of
13 the historic or present tense statements made by the Defendants was an assumption underlying or
14 relating to any plan, projection or statement of future economic performance, as they were not
15 stated to be such an assumption underlying or relating to any projection or statement of future
16 economic performance when made nor were any of the projections or forecasts made by the Officer
17 Defendants, or KPMG expressly related to or stated to be dependent on those historic or present
18 tense statements when made.

19 **XII. CLAIMS FOR RELIEF**

20 **COUNT I**

21 **Violation of Section 10(b) of the Exchange Act and Rule 10b-5**
22 **Promulgated Thereunder Against Brocade, the Officer Defendants, and the Audit**
23 **Committee Defendants**

24 272. Lead Plaintiff repeats and realleges each and every allegation contained above as if
25 fully set forth herein.

26 273. During the Class Period, Brocade and the Individual Defendants, and each of them,
27 carried out a plan, scheme and course of conduct which was intended to and, throughout the Class
28 Period, did: (a) deceive the investing public, including plaintiff and other Class members, as
alleged herein; (b) artificially inflate and maintain the market price of Brocade publicly traded

1 securities; and (c) cause plaintiff and other members of the Class to purchase Brocade publicly
2 traded securities at artificially inflated prices. In furtherance of this unlawful scheme, plan and
3 course of conduct, Defendants, and each of them, took the actions set forth herein.

4 274. Brocade, and the Officer Defendants; (a) employed devices, schemes, and artifices to
5 defraud; (b) made untrue statements of material fact and/or omitted to state material facts necessary
6 to make the statements made not misleading; and (c) engaged in acts, practices, and a course of
7 business which operated as a fraud and deceit upon the purchasers of the Company's securities in an
8 effort to maintain an artificially high market price for Brocade's publicly traded securities in
9 violation of § 10(b) of the Exchange Act and Rule 10b-5. All Defendants are sued either as primary
10 participants in the wrongful and illegal conduct charged herein, or as controlling persons as alleged
11 below.

12 275. In addition to the duties of full disclosure imposed on Brocade, and the Officer
13 Defendants, as a result of their making of affirmative statements and reports, or participation in the
14 making of affirmative statements and reports to the investing public, Brocade, and the Officer
15 Defendants had a duty to promptly disseminate truthful information that would be material to
16 investors in compliance with the integrated disclosure provisions of the SEC as embodied in SEC
17 Regulation S-X (17 C.F.R. §210.01, *et seq.*) and Regulation S-K (17 C.F.R. §229.10, *et seq.*) and
18 other SEC regulations, including accurate and truthful information with respect to the Company's
19 operations, financial condition and earnings so that the market prices of the Company's securities
20 would be based on truthful, complete and accurate information.

21 276. Brocade and the Individual Defendants, individually and in concert, directly and
22 indirectly, by the use, means or instrumentalities of interstate commerce and/or of the mails,
23 engaged and participated in a continuous course of conduct to conceal adverse material information
24 about the business, operations and future prospects of Brocade as specified herein.

25 277. Brocade and the Individual Defendants employed devices, schemes and artifices to
26 defraud, while in possession of material adverse non-public information and engaged in acts,
27 practices, and a course of conduct as alleged herein in an effort to assure investors of Brocade's
28 value and performance and continued substantial growth, which included the making of, or the

1 participation in the making of, untrue statements of material facts and omitting to state material
2 facts necessary in order to make the statements made about Brocade and its business operations and
3 future prospects in the light of the circumstances under which they were made, not misleading, as
4 set forth more particularly herein, and engaged in transactions, practices and a course of business
5 which operated as a fraud and deceit upon the purchasers of Brocade publicly traded securities
6 during the Class Period.

7 278. The Individual Defendants' primary liability, and controlling person liability, arises
8 from the following facts: (a) the Individual Defendants were high-level executives and/or directors
9 at the Company during the Class Period; (b) the Individual Defendants were privy to and
10 participated in the creation, development and reporting of the Company's internal budgets, plans,
11 projections and/or reports; and (c) the Individual Defendants were aware of the Company's
12 dissemination of information to the investing public which they knew or recklessly disregarded was
13 materially false and misleading.

14 279. Brocade and the Individual Defendants had actual knowledge of the
15 misrepresentations and omissions of material facts set forth herein, or acted with reckless disregard
16 for the truth in that they failed to ascertain and to disclose such facts, even though such facts were
17 available to them. Brocade's and the Individual Defendants' material misrepresentations and/or
18 omissions were done knowingly or recklessly and for Defendants' material misrepresentations
19 and/or omissions were done knowingly or recklessly and for the purpose and effect of concealing
20 Brocade's operating condition and future business prospects from the investing public and
21 supporting the artificially inflated price of its securities. As demonstrated by Brocade's and the
22 Individual Defendants' overstatements and misstatements of the Company's business, operations
23 and earnings throughout the Class Period, Brocade and the Individual Defendants, if they did not
24 have actual knowledge of the misrepresentations and omissions alleged, were reckless in failing to
25 obtain such knowledge by deliberately refraining from taking those steps necessary to discover
26 whether those statements were false or misleading.

27 280. As a result of the dissemination of the materially false and misleading information
28 and failure to disclose material facts, as set forth above, the market prices of Brocade publicly

1 traded securities were artificially inflated during the Class Period. In ignorance of the fact that the
2 market prices of Brocade publicly traded securities were artificially inflated, and relying directly or
3 indirectly on the false and misleading statements made by Brocade and the Individual Defendants,
4 or upon the integrity of the market in which the securities trade, and/or on the absence of material
5 adverse information that was known to or recklessly disregarded by Defendants but not disclosed in
6 public statements by Defendants during the Class Period, Lead Plaintiff and the other members of
7 the Class acquired Brocade publicly traded securities during the Class Period at artificially high
8 prices and were damaged thereby.

9 281. At the time of said misrepresentations and omissions, Lead Plaintiff and other
10 members of the Class were ignorant of their falsity, and believed them to be true. Had Lead Plaintiff
11 and the other members of the Class and the marketplace known of the true financial condition and
12 business prospects of Brocade, which were not disclosed by Brocade and the Individual Defendants,
13 Lead Plaintiff and other members of the Class would not have purchased or otherwise acquired their
14 Brocade publicly traded securities, or, if they had acquired such securities during the Class Period,
15 they would not have done so at the artificially inflated prices which they paid.

16 282. By virtue of the foregoing, Brocade and the Individual Defendants have violated §
17 10(b) of the Exchange Act, and Rule 10b-5 promulgated thereunder.

18 283. As a direct and proximate result of Brocade's and the Individual Defendants'
19 wrongful conduct, Lead Plaintiff and the other members of the Class suffered damages in
20 connection with their respective purchases and sales of the Company's publicly traded securities
21 during the Class Period.

22 **COUNT II**

23 **Violation of Section 20(a) of** 24 **the Exchange Act Against the Officer Defendants**

25 284. Lead Plaintiff repeats and realleges each and every allegation contained above as if
26 fully set forth herein.

27 285. The Officer Defendants acted as controlling persons of Brocade within the meaning
28 of §20(a) of the Exchange Act as alleged herein. By virtue of their high-level positions, and their

1 ownership and contractual rights, participation in and/or awareness of the Company's operations
2 and/or intimate knowledge of the statements filed by the Company with the SEC and disseminated
3 to the investing public, the Officer Defendants had the power to influence and control and did
4 influence and control, directly or indirectly, the decision-making of the Company, including the
5 content and dissemination of the various statements which plaintiff contends are false and
6 misleading. The Officer Defendants were provided with or had unlimited access to copies of the
7 Company's reports, press releases, public filings and other statements alleged by Lead Plaintiff to be
8 misleading prior to and/or shortly after these statements were issued and had the ability to prevent
9 the issuance of the statements or cause the statements to be corrected.

10 286. In particular, the Officer Defendants had direct and supervisory involvement in the
11 day-to-day operations of the Company and, therefore, are presumed to have had the power to
12 control or influence the particular transactions giving rise to the securities violations as alleged
13 herein, and exercised the same.

14 287. During the Class Period, the Officer Defendants, as senior executive officers and/or
15 directors of Brocade, were privy to confidential and proprietary information concerning Brocade, its
16 operations, finances, financial condition and present and future business prospects. The Officer
17 Defendants also had access to material adverse non-public information concerning Brocade, as
18 discussed in detail below. Because of their positions with Brocade, the Officer Defendants had
19 access to non-public information about its business, finances, products, markets and present and
20 future business prospects via access to internal corporate documents, conversations and connections
21 with other corporate officers and employees, attendance at management and/or board of directors
22 meetings and committees thereof and via reports and other information provided to them in
23 connection therewith. Because of their possession of such information, the Officer Defendants knew
24 or recklessly disregarded that the adverse facts specified herein had not been disclosed to, and were
25 being concealed from, the investing public.

26 288. The Officer Defendants are liable as direct participants in the wrongs complained of
27 herein. In addition, the Officer Defendants, by reason of their status as senior executive officers
28 and/or directors, were "controlling persons" within the meaning of §20(a) of the Exchange Act and

1 had the power and influence to cause the Company to engage in the unlawful conduct complained
2 of herein. Because of their positions of control, the Officer Defendants were able to and did, directly
3 or indirectly, control the conduct of Brocade's business.

4 289. The Officer Defendants, because of their positions with the Company, controlled
5 and/or possessed the authority to control the contents of its reports, press releases and presentations
6 to securities analysts and through them, to the investing public. The Officer Defendants were
7 provided with copies of the Company's reports and press releases alleged herein to be misleading,
8 prior to or shortly after their issuance and had the ability and opportunity to prevent their issuance
9 or cause them to be corrected. Thus, the Officer Defendants had the opportunity to commit the
10 fraudulent acts alleged herein.

11 290. As senior executive officers and/or directors and as controlling persons of a publicly
12 traded company whose common stock was, and is, registered with the SEC pursuant to the
13 Exchange Act and was traded on the NASDAQ and governed by the federal securities laws, the
14 Officer Defendants had a duty to disseminate promptly accurate and truthful information with
15 respect to Brocade's financial condition and performance, growth, operations, financial statements,
16 business, products, markets, management, earnings and present and future business prospects, to
17 correct any previously issued statements that had become materially misleading or untrue, so that
18 the market price of Brocade's securities would be based upon truthful and accurate information. The
19 Officer Defendants' misrepresentations and omissions during the Class Period violated these
20 specific requirements and obligations.

21 291. The Officer Defendants are liable as participants in a fraudulent scheme and course
22 of conduct that operated as a fraud or deceit on purchasers of Brocade publicly traded securities by
23 disseminating materially false and misleading statements and/or concealing material adverse facts.

24 292. The Officer Defendants controlled the Company and all of its employees. As set
25 forth above, Brocade and the Officer Defendants each violated §10(b) and Rule 10b-5 by their acts
26 and omissions as alleged in this Complaint. By virtue of their positions as controlling persons, the
27 Defendants are liable pursuant to §20(a) of the Exchange Act. As a direct and proximate result of
28 Brocade's and the Officer Defendants' wrongful conduct, Lead Plaintiff and other members of the

1 Class suffered damages in connection with their purchases of the Company's publicly traded
2 securities during the Class Period.

3 **COUNT III**

4 **Against Defendant KPMG For Violations**
5 **of Section 10(b) of the Exchange Act and Rule 10b-5(b)**

6 293. Lead Plaintiff repeats and realleges each and every allegation above as though set
7 forth fully herein.

8 294. This Count is brought pursuant to Section 10(b) of the Exchange Act and Rule 10b-
9 5(b) against KPMG on behalf of Lead Plaintiff and other members of the Class who purchased or
10 otherwise acquired Brocade securities during the Class Period.

11 295. KPMG issued unqualified opinions for Brocade's Financial Statements for Fiscal
12 Years 2002, 2003 and 2004, which, as described above, falsely stated that it had conducted its
13 audits in accordance with GAAS and that, in its opinion, Brocade's financial statements were
14 prepared in accordance with GAAP.

15 296. As set forth above, during the Class Period, Brocade, by use of the means or
16 instrumentalities of interstate commerce, the mails, and/or the facilities of a national securities
17 exchange, engaged and participated in a continuous course of conduct to materially misstate
18 Brocade's reported financial results, and made untrue statements of material fact and/or omitted to
19 state material facts necessary in order to make statements made, in light of the circumstances under
20 which they were made, not misleading.

21 297. By virtue of the foregoing, KPMG violated Section 10(b) of the Exchange Act and
22 Rule 10b-5(b) promulgated thereunder.

23 298. Lead Plaintiff and the other members of the Class suffered damages because, in
24 reliance on the integrity of the market, they paid artificially inflated prices for the publicly traded
25 securities of Brocade. Lead Plaintiff and the other members of the Class would not have purchased
26 the publicly traded securities of Brocade at the prices they paid, if at all, had they known that the
27 market prices of those securities were artificially inflated by the unlawful actions and omissions by
28 KPMG.

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XIII. PRAYER FOR RELIEF

299. WHEREFORE, Lead Plaintiff prays for relief and judgment, as follows:

A. Determining that this action is a proper class action under Rule 23 of the Federal Rules of Civil Procedure;

B. Awarding compensatory damages in favor of Lead Plaintiff and the other members of the Class against all Defendants for all damages sustained as a result of Defendants' wrongdoing, in an amount to be proven at trial, including interest thereon;

C. Awarding Lead Plaintiff and the Class their reasonable costs and expenses incurred in this action, including counsel fees and expert fees; and

D. Such other and further relief as the Court may deem just and proper.

XIV. JURY TRIAL DEMAND

300. Lead Plaintiff hereby demands a trial by jury.

DATED: April 14, 2006

Respectfully Submitted,

/s/

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Linda M. Fong (State Bar No. 124232)
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Co-Lead Counsel

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PROOF OF SERVICE

I, Adrianna D. Gutierrez, declare that I am over the age of eighteen (18) and not a party to the within action. I am employed in the law firm of Kaplan Fox & Kilsheimer LLP, 555 Montgomery Street, San Francisco, California 94111.

On April 14, 2006, I used the Northern District of California’s Electronic Case Filing System, with the ECF registered to Laurence D. King to file following document(s):

CONSOLIDATED CLASS ACTION COMPLAINT

The ECF system is designed to send an e-mail message to all parties in the case, which constitutes service. According to the ECF/PACER system, for this case, the parties served are as follows:

- Richard A. Adams -- radams@pattonroberts.com; mcosta@pattonroberts.com
- Brian Joseph Barry, Esq -- bribarry1@yahoo.com
- Bradley E. Beckworth -- BBeckworth@nixlawfirm.com; sandiclark@nixlawfirm.com; SWhatley@nixlawfirm.com
- Eric J. Belfi -- ebelfi@murrayfrank.com
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- David Andrew McCarthy -- dmccarthy@wsgr.com; vmendoza@wsgr.com
- George L. McWilliams -- gmcwilliams@pattonroberts.com
- Arthur L. Shingler, III -- ashingler@scott-scott.com; ssawyer@scott-scott.com
- Robin Winchester – ecf_filings@sbclasslaw.com

On this date, I served the below parties:

Aaron L. Brody Jules Brody Tzivia Brody STULL STULL & BRODY 6 East 45th Street New York, NY 10017 Telephone: 212-687-7320 Facsimile: 212-490-2022	David R. Scott Arthur L. Shingler, III SCOTT & SCOTT LLC 108 Norwich Avenue Colchester, CT 06415 Telephone: 860-537-3818 Facsimile: 860-537-4432 Email: drscott@scott-scott.com
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Executed April 14, 2006 at San Francisco, California.

Adrianna D. Gutierrez