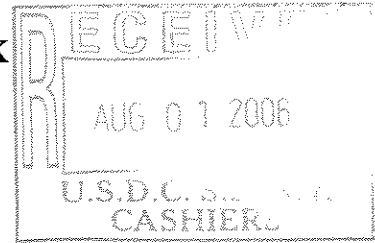


UNITED STATES DISTRICT COURT  
SOUTHERN DISTRICT OF NEW YORK



POLICE AND FIRE RETIREMENT  
SYSTEM OF THE CITY OF DETROIT,  
On Behalf of Itself and All Others  
Similarly Situated,

Plaintiff,

v.

SAFENET, INC., ANTHONY A.  
CAPUTO, KENNETH A. MUELLER,  
CAROLE D. ARGO, THOMAS A.  
BROOKS, IRA A. HUNT, Jr., BRUCE  
R. THAW, ARTHUR L. MONEY,  
SHELLEY A. HARRISON, ANDREW  
E. CLARK, and WALTER W. STRAUB.

Defendants.

No.

CLASS ACTION COMPLAINT FOR  
VIOLATIONS OF THE FEDERAL  
SECURITIES LAWS SEEKING MONEY  
DAMAGES AND EQUITABLE RELIEF

DEMAND FOR TRIAL BY JURY

Plaintiff brings this securities fraud action individually on behalf of itself and as a class action on behalf of all persons or entities who purchased the common stock of SafeNet, Inc. ("SafeNet" or the "Company") during the period from March 31, 2003 through and including May 18, 2006 (the "Class Period"). Plaintiff alleges the following facts upon knowledge, with respect to its own acts, and with respect to all other facts based on an investigation conducted by its counsel, including, among other things, a review of SafeNet's public filings and press releases, news and research reports about the Company, and upon other information available to the public.

## **NATURE OF THE ACTION**

1. During the Class Period, SafeNet and the Individual Defendants (who are defined below) (collectively, “Defendants”) issued numerous false and misleading public statements pertaining to SafeNet’s stock option grants and executive compensation policies and practices. SafeNet and certain of the Defendants issued false and misleading proxy statements in violation of Section 14(a) of the Securities Exchange Act of 1934 (the “Exchange Act”) and issued various other false and misleading statements regarding SafeNet’s financial condition in violation of Section 10(b), 15 U.S.C. § 78j(b), and Rule 10b-5 promulgated thereunder by the United States Securities and Exchange Commission (“SEC”).

2. Throughout the Class Period, the Individual Defendants caused SafeNet to confer upon them multi-million dollar windfall profits through improper administration of SafeNet’s stock option plans and failed to disclose to the investing public the fact and implications for SafeNet investors of their conduct. When these improper grants were finally revealed to investors, the price of SafeNet stock declined dramatically, causing investors losses and damages.

3. As further detailed below, in addition to issuing financial statements that falsely portrayed SafeNet’s financial condition by virtue of understating compensation costs and omitting critical facts regarding SafeNet’s executive compensation, Defendants also violated Generally Accepted Accounting Principles (“GAAP”) regarding SafeNet’s revenues and expenses relating to certain long-term product development contracts. Through a series of disclosures at and near the end of the Class Period, Defendants finally admitted their wrongdoing by restating SafeNet’s reported financial results for the second and third quarters of 2005, causing the value of SafeNet shares to drop precipitously. In reliance upon the veracity of

Defendants' false and misleading statements, Plaintiff and the other members of the Class purchased shares of SafeNet stock at artificially inflated prices and were injured after the truth emerged and the value of SafeNet shares declined.

### **JURISDICTION AND VENUE**

4. This Court has jurisdiction over the subject matter of this action under Section 27 of the Exchange Act, 15 U.S.C. § 78aa, and under 28 U.S.C. §§ 1331 and 1337. The claims alleged herein arise under Section 14(a) of the Exchange Act and Rule 14a-9 promulgated thereunder and Sections 10(b) and 20(a) of the Exchange Act and Rule 10b-5 promulgated thereunder.

5. Venue is proper in this District pursuant to Section 27 of the Exchange Act and 28 U.S.C. § 1391(b). Many of the acts and transactions giving rise to the violations of law complained of herein, including the preparation and dissemination to the investing public of false and misleading public statements and SEC filings, occurred in this District.

6. In connection with the wrongful acts and conduct alleged herein, Defendants, directly and indirectly, used the means and instrumentalities of interstate commerce, including the United States mail and the facilities of the NASDAQ, a national securities market located in this District. Further, as is described below, the Office of the United States Attorney for the Southern District of New York is conducting an investigation into certain of the Company's stock options granting practices, which comprise a substantial part of the wrongful conduct alleged herein.

### **THE PARTIES**

#### **A. Plaintiff**

7. Plaintiff the Police and Fire Retirement System of the City of Detroit ("Detroit

Police and Fire”) purchased 93,865 shares of common stock of SafeNet during the Class Period as set forth in the attached certification and suffered damages as a result of the violations of the federal securities laws pled herein. Detroit Police and Fire is a public pension fund with more than \$3.8 billion of net assets held in trust as of June 30, 2005 for the benefit of the active and retired police officers and firefighters of the City of Detroit, Michigan.

**B. SafeNet and the Officer Defendants**

8. Defendant SafeNet develops, markets and sells a portfolio of hardware and software information security products and services used to protect and secure digital identities, communications and applications. SafeNet is a Delaware corporation and is headquartered in Belcamp, Maryland.

9. At all times relevant hereto, defendant Anthony A. Caputo (“Caputo”) has been Chief Executive Officer and Chairman of the Board of Directors (the “Board”) of SafeNet. During the Class Period, Mr. Caputo manipulated SafeNet’s options granting process or improperly used material nonpublic information in order to cause SafeNet to improperly grant to him 400,000 options to purchase SafeNet stock at strike prices ranging between \$13.75 and \$29.70, and to fail to properly disclose the nature of these grants to the investing public. Also, while in possession of material nonpublic information about SafeNet’s business, Caputo sold 287,500 shares of SafeNet stock at prices between \$23.97 and \$36.63 per share for total proceeds of \$8.3 million.

10. From the beginning of the Class Period until on or about April 7, 2006, defendant Kenneth A. Mueller (“Mueller”) was Senior Vice President and Chief Financial Officer of SafeNet. During the Class Period, Mr. Mueller manipulated SafeNet’s options granting process or improperly used material nonpublic information in order to cause SafeNet to improperly grant

to him 150,000 options to purchase SafeNet stock at prices between \$22.19 and \$29.70, and to fail to properly disclose the nature of these grants to the investing public. Also, while in possession of material nonpublic information about SafeNet's business, Mueller sold 12,500 shares of SafeNet stock at a price of \$36.61 per share for total proceeds of \$457,625.

11. At all times relevant hereto, defendant Carole D. Argo ("Argo") has been President and Chief Operating Officer of SafeNet and, from April 7, 2006 through the end of the Class Period, Ms. Argo was the interim Chief Financial Officer of SafeNet. During the Class Period, Ms. Argo manipulated SafeNet's options granting process or improperly used material nonpublic information in order to cause SafeNet to improperly grant to her 200,000 options to purchase SafeNet stock at strike prices ranging between \$16.47 and \$31.35, and to fail to properly disclose the nature of these grants to the investing public. Also, while in possession of material nonpublic information about SafeNet's business, Ms. Argo sold 30,000 shares of SafeNet stock at a price of \$36.01 per share for total proceeds of \$1.1 million.

12. Each of the defendants named in paragraphs 8 through 11 above (collectively, the "Officer Defendants") had access to undisclosed material information about the Company's business, operations, products, operational trends, financial statements and future business prospects as a result of their access to internal corporate documents and their work with other SafeNet executives, officers and directors.

13. The Officer Defendants were responsible for, participated in the preparation of, or were aware of, the false and misleading SEC filings, press releases, and other statements complained of herein at or about the time they were issued or circulated. These Defendants knew or recklessly disregarded the false and misleading nature of the statements complained of herein and were in a position to control or influence their contents or otherwise cause corrective

or accurate disclosures to be made. Because of their Board memberships or executive and managerial positions, each of these Defendants was responsible for ensuring the truth and accuracy of the various statements contained in the Company's public statements and SEC filings.

**C. The Director Defendants**

14. At all relevant times hereto, defendant Thomas A Brooks ("Brooks") has served as a director of the Company and a member of the Company's Compensation Committee and Audit Committee. As a portion of his compensation for serving as a director, Brooks received stock options, as described below. During the Class Period, Brooks signed each of the Company's Form 10-Ks and authorized and permitted the use of his name in the 2003-2005 proxies. According to the Form 4 statements that Safenet and Mr. Brooks filed during the Class Period, Mr. Brooks received 37,767 options to purchase SafeNet stock at strike prices ranging between \$11.75 and \$31.69 and sold 36,617 shares of SafeNet stock at prices between \$26.20 and \$36.21 per share for total proceeds of \$1.1 million. On July 3, 2006, Safenet disclosed that Mr. Brooks failed to file Form 4 statements for certain options grants during the Class Period.

15. At all relevant times hereto, defendant Ira A. Hunt, Jr. ("Hunt") has served as a director of the Company and a member of the Audit Committee and he served on the Company's Compensation Committee until 2004. As a portion of his compensation for serving as a director, Hunt received stock options, as described below. During the Class Period, Hunt signed each of the Company's Form 10-Ks and authorized and permitted the use of his name in the 2003-2005 proxies. According to the Form 4 statements that Safenet and Mr. Hunt filed during the Class Period, Mr. Hunt received 15,000 options to purchase SafeNet stock at strike prices ranging between \$9.19 and \$21.31 and sold 11,000 shares of SafeNet stock at prices between \$35.87 and

\$36.11 per share for total proceeds of \$396,506. On July 3, 2006, Safenet disclosed that Mr. Hunt failed to file Form 4 statements for certain options grants during the Class Period.

16. At all relevant times hereto, defendant Bruce R. Thaw (“Thaw”) has served as a director of the Company and has served on the Company’s Compensation Committee since 2004. As a portion of his compensation for serving as a director, Thaw received stock options, as described below. During the Class Period, Thaw signed each of the Company’s Form 10-Ks and authorized and permitted the use of his name in the 2003-2005 proxies. According to the Form 4 statements that Safenet and Mr. Thaw filed during the Class Period, Mr. Thaw received 48,667 options to purchase SafeNet stock at strike prices ranging between \$9.19 and \$31.69 and sold 48,667 shares of SafeNet stock at prices between \$29.30 and \$37.29 per share for total proceeds of \$1.6 million. On July 3, 2006, Safenet disclosed that Mr. Thaw failed to file Form 4 statements for certain options grants during the Class Period.

17. Since March 16, 2004, Arthur L. Money (“Money”) has served as a director of the Company and as a member of the Company’s Compensation Committee and Audit Committee. As a portion of his compensation for serving as a director, Money received stock options, as described below. Since joining the Company, Money signed the Company’s Form 10-Ks and authorized and permitted the use of his name in the 2004-2005 proxies. Defendants Brooks, Hunt, Thaw and Money, collectively, constitute the “Compensation Committee Defendants.”

18. At all relevant times hereto, defendant Shelley A. Harrison (“Harrison”) has served as a director of the Company. Since May 1, 2003, Harrison has also served as a part-time consultant to the Company. As a portion of his compensation for serving as a director and as a part-time consultant, Harrison received stock options, as described below. During the Class

Period, Harrison signed each of the Company's Form 10-Ks and authorized and permitted the use of his name in the 2003-2005 proxies. According to the Form 4 statements that Safenet and Mr. Harrison filed during the Class Period, Mr. Harrison received 66,667 options to purchase SafeNet stock at strike prices ranging between \$11.47 and \$31.69 and sold 66,667 shares of SafeNet stock at prices between \$27.59 and \$36.82 per share for total proceeds of \$2.1 million. On July 3, 2006, Safenet disclosed that Mr. Harrison failed to file Form 4 statements for certain options grants during the Class Period.

19. At all relevant times hereto, defendant Andrew E. Clark ("Clark") has served as a director of the Company. As a portion of his compensation for serving as a director, Clark received stock options, as described below. During the Class Period, Clark signed the Company's 2004 and 2005 Form 10-Ks and authorized and permitted the use of his name in the 2003-2005 proxies. According to the Form 4 statements that Safenet and Mr. Clark filed during the Class Period, Mr. Clarke received 30,000 options to purchase SafeNet stock at strike prices ranging between \$11.47 and \$16.47 and sold 28,250 shares of SafeNet stock at prices between \$23.68 and \$36.68 per share for total proceeds of \$883,393. On July 3, 2006, Safenet disclosed that Mr. Clark failed to file Form 4 statements for certain options grants during the Class Period.

20. Since March 16, 2004, Walter W. Straub ("Straub") has served as a director of the Company. As a portion of his compensation for serving as a director, Straub received stock options, as described below. During the Class Period, Straub signed the Company's 2004 and 2005 Form 10-Ks and authorized and permitted the use of his name in the 2003-2005 proxies. According to the Form 4 statements that Safenet and Mr. Straub filed during the Class Period, Mr. Straub received 107,304 options to purchase SafeNet stock at strike prices ranging between \$9.81 and \$16.72 and sold 143,449 shares of SafeNet stock at prices between \$20.44 and \$34.38



per share for total proceeds of \$4.5 million. On July 3, 2006, Safenet disclosed that Mr. Straubb failed to file Form 4 statements for certain options grants during the Class Period. The Compensation Committee Defendants, together with defendants Harrison, Clark and Straub, collectively, constitute the “Director Defendants.”

21. The Officer Defendants and Director Defendants (collectively, the “Individual Defendants”) were each controlling persons of SafeNet within the meaning of Section 20 of the Exchange Act by reason of their management positions in SafeNet or their membership on the Company’s Board. Because of their positions in the Company, the Individual Defendants had the power and influence to cause SafeNet to engage in the unlawful acts and conduct alleged herein.

### **CLASS ACTION ALLEGATIONS**

22. Plaintiff Detroit Police and Fire brings this action on its own behalf and as a class action pursuant to Rule 23(a) and Rule 23(b)(3) of the Federal Rules of Civil Procedure on behalf of a class (the “Class”) of all persons who purchased or acquired SafeNet common stock during the period from March 31, 2003 through May 18, 2006, inclusive (the “Class Period”), including all investors who owned SafeNet stock at the time SafeNet’s 2003, 2004 and 2005 Proxy Statements were circulated to solicit shareholder votes on various matters. Excluded from the Class are the Defendants herein, members of the family of each of the Individual Defendants, executive officers and/or directors of SafeNet, any person, firm, trust, corporation, officer, director or other individual or entity in which any Defendant has a controlling interest or which is related to or affiliated with any of the Defendants, and the legal representatives, agents, affiliates, heirs, successors-in-interest or assigns of any such excluded party.

23. SafeNet common stock was actively traded on the NASDAQ electronic exchange,

which is an efficient market, throughout the Class Period. Numerous securities analysts published reports about SafeNet during the Class Period, including analysts from Avondale Partners LLC, Brean Murray Carret & Co., Deutsche Bank Securities, First Analysis, Friedman Billings Ramsey Co., Janney Montgomery Scott, Kaufman Brothers, Legg Mason, Lehman Brothers, Morgan Stanley Co., Morgan Keegan & Co., Pacific Growth Equities, Raymond James, Sterne Agee & Leach, Stifel Nicolaus & Co., Wachovia Securities, Wedbush Morgan Securities. Hundreds of thousands of Company shares were traded every day during the Class Period, and over a million SafeNet shares were traded on numerous days.

24. The members of the Class, as purchasers on the NASDAQ, are so numerous that joinder of all members is impracticable. While the exact number of Class members can only be determined by appropriate discovery, plaintiff believes that Class members number in the thousands. As of May 4, 2006, SafeNet had 27,546,926 shares of common stock issued and outstanding.

25. Plaintiff's claims are typical of the claims of the members of the Class. Plaintiff and all members of the Class sustained damages as a result of the wrongful conduct complained of herein.

26. 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. Plaintiff has no interests that are contrary to or in conflict with those of the members of the Class that Plaintiff seeks to represent.

27. A class action is superior to other available methods for the fair and efficient adjudication of this controversy. Because the damages suffered by individual Class members may be relatively small, the expense and burden of individual litigation make it virtually

impossible for the plaintiff Class members individually to seek redress for the wrongful conduct alleged.

28. 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 the documents, releases and public statements made by Defendants omitted to state and/or misrepresented material facts concerning, among other things, the Company's financial results, including its revenues and expenses, the Company's internal controls and financial reporting processes and functions, and the Company's improper practices with respect to the grant to executives of SafeNet stock options;
- c. whether Defendants acted knowingly or recklessly in misrepresenting material facts;
- d. whether the market price of SafeNet stock during the Class Period was artificially inflated due to the material misrepresentations complained of herein; and
- e. whether the members of the Class have sustained damages and, if so, the appropriate measure thereof.

29. Plaintiff knows of no difficulty that will be encountered in the management of this litigation that would preclude its maintenance as a class action.

30. The names and addresses of the record owners of SafeNet shares purchased during the Class Period are available from the Company's transfer agent(s). Notice can be provided to such record owners via first class mail using techniques and a form of notice similar to those customarily used in class actions.

#### **FRAUD-ON-THE-MARKET DOCTRINE**

31. At all relevant times, SafeNet's common stock traded in an efficient market for the following reasons, among others:

- a. SafeNet's common stock met the requirements for public listing and was listed

and actively traded on the NASDAQ, a highly efficient market;

b. As a regulated issuer, SafeNet filed periodic public reports with the SEC;

c. SafeNet regularly issued press releases that were carried by national news wires and that were publicly available and entered the public marketplace; and

d. Numerous research analysts and other market professionals followed and publicly reported on SafeNet's public statements.

32. The market for SafeNet's common stock promptly digested current information with respect to SafeNet from all publicly available sources and reflected such information in the price for SafeNet stock. All purchasers of the Company's publicly traded securities during the Class Period suffered similar injury through their purchase of SafeNet stock at artificially inflated prices and a presumption of reliance applies.

### **FACTUAL ALLEGATIONS**

#### **A. Background on Stock Option Practices and Defendants' False and Misleading Compensation-Related Disclosures**

33. A stock option allows the recipient to purchase a specific number of shares at a preset price. Public companies like SafeNet typically grant stock options as part of their executive compensation. After options are granted as incentive compensation, if the market price of the company's stock has increased since the date of the grant, the executive will typically be able to enjoy economic benefits in line with the benefits that shareholders experience by virtue of the company's (and the executive's) performance.

34. Throughout the Class Period, the members of SafeNet's Compensation Committee were charged with responsibility to oversee implementation of the Company's 2001

Omnibus Stock Option Plan (the “Stock Option Plan”) and all other stock option grants to all executives. By issuing the false and misleading proxy statements identified below, SafeNet solicited and obtained approval from its shareholders for the Stock Option Plan and various expansions of the aggregate number of options that could be issued pursuant to the Plan.

35. Once shareholder approval was obtained for authorization of the Stock Option Plan and the number of shares that could be issued, it became the Compensation Committee’s responsibility to approve the number of options to be granted to executives, the timing of grants to executives and the number of shares to be reserved under the Plan. If SafeNet complied with the terms of its own plan, then no stock options could be granted to executives, including the Officer Defendants, without oversight and approval by the Compensation Committee.

36. As further detailed below, Defendants failed to properly disclose the manner in which it implemented the Stock Option Plan and failed to disclose that SafeNet granted stock options to executives through various improper means.

37. Options may be improperly granted in several ways that benefit executives at the expense of the corporation and its investors. “Backdating” an option grant means changing an option’s grant date to an earlier date when the market price of the underlying stock was lower than on the actual date the option was granted. This practice improperly allows company officials to profit by setting the strike price of options with the benefit of hindsight instead of setting option strike prices at the then-current price. Backdating is the functional equivalent of using today’s Wall Street Journal to buy or sell stocks based on yesterday’s trading prices.

38. “Spring-loading” an option grant is timing an option grant immediately in advance of materially positive news in order to give the recipient of the option the benefit of a strike price that is *understated* because the market is unaware of the materially positive

developments and has not incorporated such news into the stock price. Put another way, the executive receiving the options immediately benefits because the market is unaware that the stock price is actually too low, so the executive improperly profits by taking advantage of the information he or she was only able to obtain by virtue of his or her position of power with the company.

39. A recurring pattern of incredibly well-timed stock option grants strongly supports the conclusion that the issuing corporation and the executives involved in the process or receiving those grants improperly administered the process in order to enrich themselves at the expense of the investing public. As shown below, SafeNet's history of option grants to executives is so consistently suspicious and so consistently provided executives with abnormal and outsize favorable economic returns that the only statistically reasonable conclusion, in light of Defendants' recent disclosures regarding the inquiries into Defendants' failure to timely disclose option grants, is that Defendants improperly backdated and/or spring-loaded option grants, and then failed to properly disclose the fact and economic implications of those grants in SafeNet's public statements.

40. SafeNet's and the Individual Defendants' statements regarding its option granting policies and practices were important because investors and regulators view executive compensation as particularly material. Consequently, SEC and accounting rules prescribe detailed and specific public disclosure of the compensation provided to corporate directors and executives.

41. GAAP are those principles recognized by the accounting profession as the conventions, rules and procedures necessary to define accepted accounting practices at particular time. SEC Regulation S-X (17 C.F.R. § 210.4-01(a)(1)) states financial statements filed with the

SEC which are not prepared in compliance with GAAP are presumed to be misleading and inaccurate, despite footnote or other disclosure. Regulation S-X requires that interim financial statements must also comply with GAAP, with the exception that interim financial statements need not include disclosure which would be duplicative of disclosures accompanying annual financial statements. 17 C.F.R. § 210.10-01(a). Pursuant to the Sarbanes-Oxley Act of 2002 and SEC rules promulgated thereunder, the CEO and CFO of reporting corporations are required to certify as to the accuracy and completeness of company's financial statements. In addition, proxy statements and annual reports are required to make extensive disclosures regarding executive compensation, including stock holdings and exercised and unexercised stock options.

42. SafeNet's own disclosures highlighted the applicable rules and purported to inform investors of the compensation cost that SafeNet incurred. Under APB 25, which applied to SafeNet's disclosures through 2005, SafeNet opted to report stock option cost by applying the "intrinsic value method." Applying this method, a stock has "intrinsic value" when a company grants options at a strike price that was below the value of the underlying stock on the day of grant. If a stock option has "intrinsic value," the issuing company is required to recognize the difference in value as an amortization expense on its financial statements.

43. Finally, applicable tax rules and regulations play a critical role in the public reporting of stock option grants to executives and their effects on financial statements. U.S. tax rules treat option grants as either "qualified" or "nonqualified," with different tax ramifications for each. The backdating of an option affects key tax determinations, including whether the option was granted at fair value, and whether the option was granted pursuant to a stock option plan validly authorized by shareholders. Consequently, the secret backdating of options can have serious tax consequences for public companies.

44. As described below, SafeNet's disclosures regarding its Stock Option Plan as well as SafeNet's practices regarding option grants were materially misstated throughout the Class Period. The investing public was told about SafeNet's improper stock option-related practices on May 18, 2006, when SafeNet disclosed as follows:

SafeNet ... today announced that it received a subpoena from the office of the United States Attorney for the Southern District of New York relating to the Company's granting of stock options. The Company also announced that it has received an informal inquiry from the Securities and Exchange Commission requesting information relating to stock option grants to directors and officers of the Company, as well as information relating to certain accounting policies and practices.

45. Investors immediately punished SafeNet's stock price on the news of the multiple investigations into the Company's stock option practices (as well as the SEC's accounting inquiry discussed below), sending the stock price spiraling downward by 21%, from \$19.21 on May 18, to \$14.93 on May 19, 2006. Additional adverse disclosures followed.

**B. Defendants' Recent Disclosures and Stock Option Grants During The Class Period Strongly Evidence Backdating and Spring-Loading**

46. Many companies issue stock options at the same time each year. Such a practice greatly reduces and perhaps eliminates the potential for "backdating" or "spring loading." As illustrated below, however, SafeNet's stock option grants during the Class Period do not follow any discernable regularity. Rather, given Defendants' recent disclosures of option-related irregularities, the timing of the options grants now appear suspiciously related to subsequent abnormal increases in the stock price and positive news announcements.

47. Throughout the Class Period, SafeNet failed to timely disclose its option grants. Specifically, in accordance with Section 403(a) of the Sarbanes-Oxley Act of 2002, 15 U.S.C. §78p(a), SafeNet was required to disclose option grants within two days of any such grant by filing a Form 4 statement with the SEC. Although Defendants filed hundreds of Form 4s during



the Class Period, Defendants failed to disclose on Form 4 the overwhelming majority of the option grants at issue in this case. Shedding additional light on the improprieties that underlie the SEC's and Department of Justice's investigations, in SafeNet's Form 14A proxy statement, filed with the SEC on July 3, 2006 (the Monday before the Fourth of July holiday), Defendants belatedly disclosed their violations of Sarbanes-Oxley as follows:

As first reported in the Company's Form 10-K/A filed with the Securities and Exchange Commission on April 11, 2006, with respect to the fiscal year ended December 31, 2005, Messrs. Brooks, Harrison and Lesem and Ms. Argo each failed to file two Forms 4 during the year to report two separate grants of stock options, and Messrs. Clark, Hunt, Money, Straub, Thaw, Caputo, Mueller (a former executive officer of the Company) and Fedde each failed to file one Form 4 during the year to report one grant of stock options;

With respect to the fiscal year ended December 31, 2004, Mr. Harrison failed to file two Forms 4 during the year to report two separate grants of stock options, and Messrs. Brooks, Clark, Hunt, Money, Straub, Thaw, Caputo, Fedde and Mueller and Ms. Argo each failed to file one Form 4 during the year to report one grant of stock options;

With respect to the fiscal year ended December 31, 2003, Messrs. Brooks, Clark, Harrison, Hunt, Thaw, Fedde and Ms. Argo each failed to file two Forms 4 during the year to report two separate grants of stock options, and Messrs. Caputo, Money and Straub each failed to file one Form 4 during the year to report one grant of stock options; and

With respect to the fiscal year ended December 31, 2002, Mr. Caputo failed to file one Form 4 to report one grant of stock options.

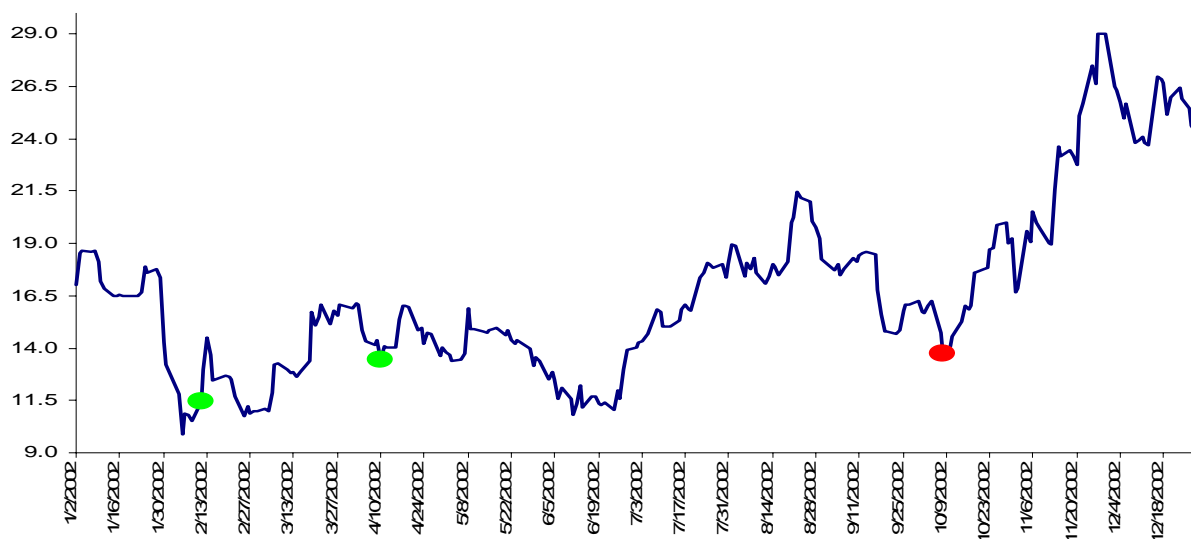
48. By not informing the market of option grants within two days of the purported grant dates, Defendants prevented investors from knowing when options were actually granted and thereby allowed themselves the opportunity to improperly manipulate or backdate those option grants. Especially in light of the current governmental inquiries, the Defendants' repeated failures to promptly notify the market of option grants increases suspicion that options were not actually granted on the dates later asserted to be the grant dates but rather that those options were actually backdated to achieve unwarranted and improper gains for executives. SafeNet's stock

option grants to executives during the Class Period are detailed below:

49. **2002 Option Grants:** The following chart shows the amounts and exercise prices of SafeNet’s stock option grants during fiscal year 2002.

Executive Name	Title	# Securities Underlying Options Granted	% of Total Options Granted to Employees in Fiscal 2002	Exercise Price Per Share	Grant Date
Anthony A. Caputo	CEO	100,000	19.60	13.75	10/8/2002
Sean R. Price	SVP world sales	20,000	3.90	11.47	2/11/2002
Chris Fedde	SVP enterprise security	15,000	2.90	11.47	2/11/2002
Cess Jan Koomen	SVP embed security	25,000	4.90	13.46	4/10/2002
		37,500	7.30	13.46	4/10/2002
		37,500	7.30	13.75	10/8/2002

50. The following graph, which marks the date of subsequently disclosed option grants against SafeNet’s closing share prices, combined with Defendants’ recent disclosures, illustrates that SafeNet’s 2002 stock option grants were suspiciously timed, in that the grants immediately or almost immediately preceded marked increases on SafeNet’s stock price.



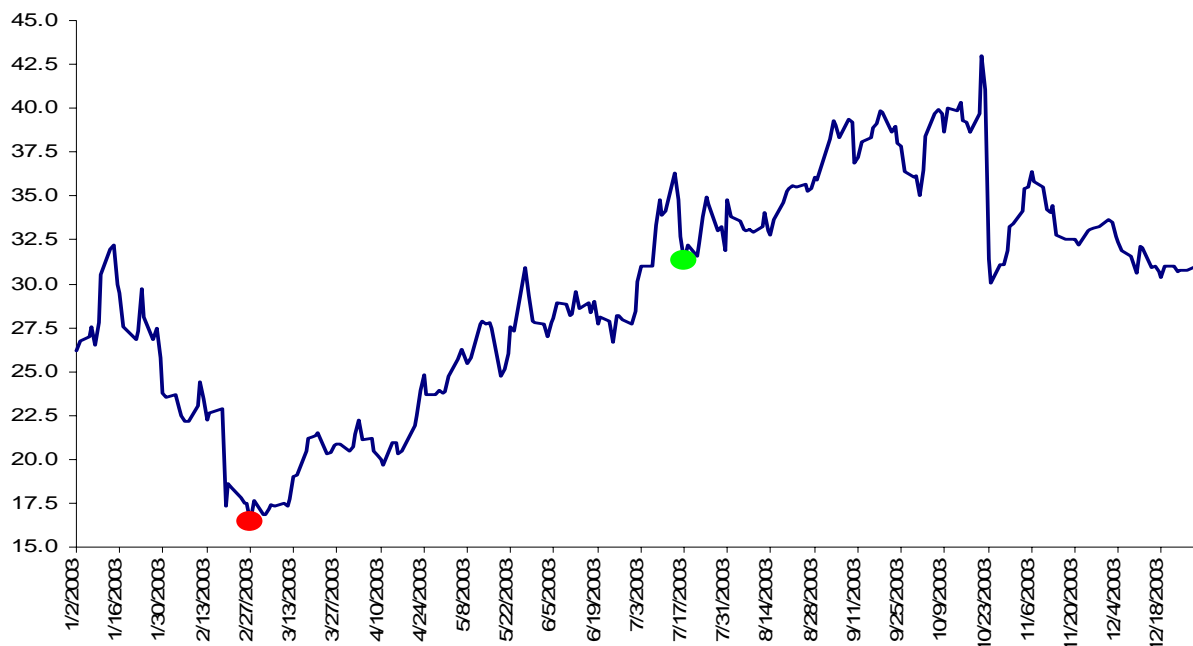
51. In light of Defendants’ recent disclosures, SafeNet’s February 11, 2002 grant of 20,000 options to Mr. Price and 15,000 to Senior Vice President Chris Fedde now appear suspicious, as the Company’s stock price increased markedly in the days that followed, from a

closing price of \$11.47 on the supposed date of the grant to \$14.48 on February 13, 2002, a mere two days after the supposed grant. SafeNet's grants to Senior Vice President Cess Jan Koomen on April 10, 2002 now appear suspicious, since the stock price increased from the \$13.46 closing price on the supposed grant date to a closing price of \$16.00 a mere seven days later, on April 17, 2002. *SafeNet's October 8, 2002 grant of 100,000 options to Defendant Caputo and 37,500 options to Jan Koomen now appear to be particularly suspicious, as the Company's stock price rose nearly 30% within the following 10 trading days.* The 2002 option grants begin to illustrate a highly suspicious pattern of SafeNet executives purportedly receiving options immediately in advance of upswings in SafeNet's stock price, and never receiving options in advance of serious declines, notwithstanding SafeNet's volatile stock price movements throughout the Class Period.

52. **2003 Option Grants:** The following chart shows the amounts and exercise prices of SafeNet's stock option grants during fiscal year 2003.

Executive Name	Title	# Securities Underlying Options Granted	% of Total Options Granted to Employees in Fiscal 2003	Exercise Price Per Share	Grant Date
Anthony A. Caputo	CEO	100,000	10.8	\$16.47	2/27/2003
Carole D. Argo	SVP CFO	40,000	4.30	16.47	2/27/2003
		10,000	1.10	31.35	7/17/2003
Sean R. Price	SVP world sales	10,000	1.10	16.47	2/27/2003
		10,000	1.10	31.35	7/17/2003
Chris Fedde	SVP enterprise security	30,000	3.2	16.47	2/27/2003
		30,000	3.2	31.35	7/17/2003
David Potts	SVP embed security	100,000	10.8	20.97	4/14/2003

53. The following graph, combined with Defendants' recent disclosures, illustrates that SafeNet's 2003 stock option grants were suspiciously timed, in that the grants immediately or almost immediately preceded marked increases on SafeNet's stock price.

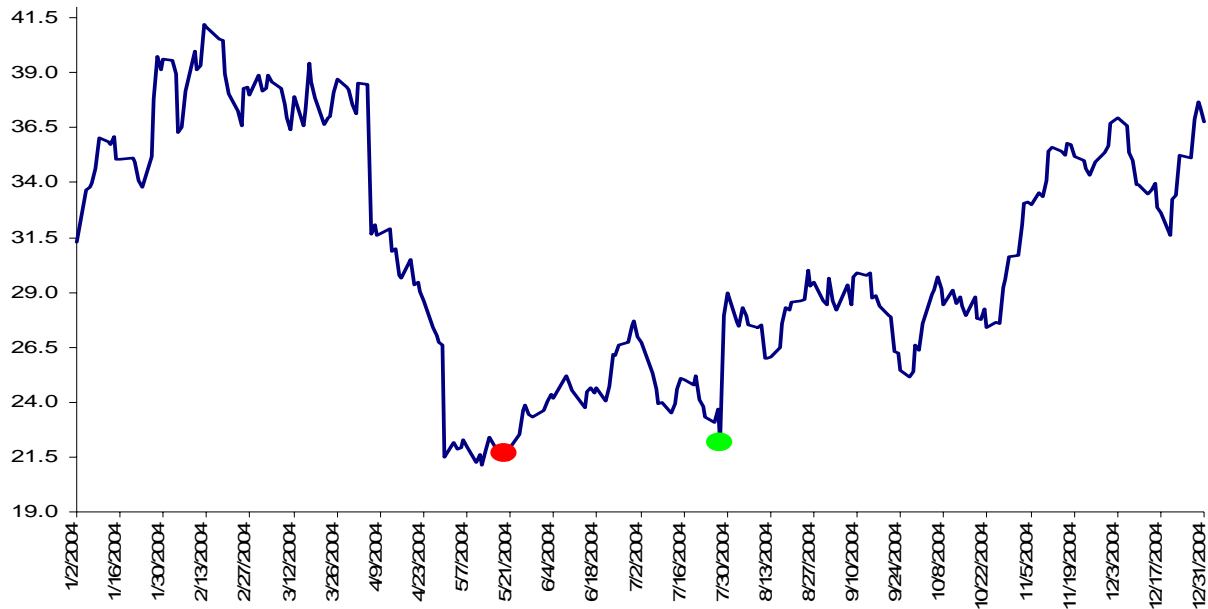


54. In light of Defendants' recent disclosures, SafeNet's February 27, 2003 grant of 100,000 options to Defendant Caputo and an additional 80,000 options among Senior Vice President Sean Price, Senior Vice President Fedde and Defendants Argo and now appear particularly suspicious, as these options were priced at *the lowest closing price for SafeNet's stock in all of 2003* and because the Company's stock price rose significantly over the following few weeks. Further, the timing of the option grants bears no apparent relation to the timing of grants in prior years.

55. **2004 Option Grants:** The following chart shows the amounts and exercise prices of SafeNet's stock option grants during fiscal year 2004.

Executive Name	Title	# Securities Underlying Options Granted	% of Total Options Granted to Employees in Fiscal 2004	Exercise Price Per Share	Grant Date
Anthony A. Caputo	CEO	100,000	10.60	21.7	5/19/2004
Carole D. Argo	President COO	100,000	10.60	21.7	5/19/2004
Kenneth A. Mueller	SVP CFO	100,000	10.60	22.19	7/28/2004
Chris Fedde	SVP enterprise security	25,000	2.60	21.7	5/19/2004
David Potts	SVP embed security	10,000	1.10	21.7	5/19/2004
Shelley A. Harrison	Director, Consultant	50,000	1.95	21.7	5/19/2004

56. The following graph, combined with Defendants' recent disclosures, illustrates that SafeNet's 2004 stock option grants were suspiciously timed, in that the grants immediately or almost immediately preceded marked increases on SafeNet's stock price.

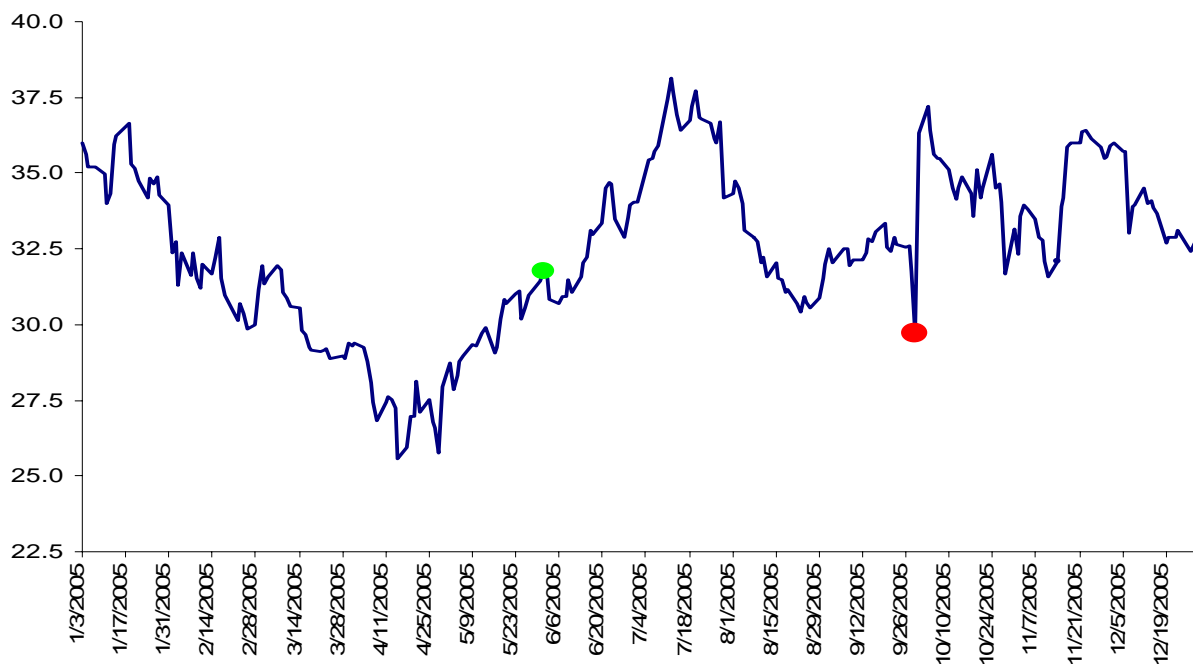


57. In light of Defendants' recent disclosures, SafeNet's May 19, 2004 grant of 235,000 options, including 100,000 to Defendant Caputo, 100,000 to Defendant Argo, 25,000 to Fedde and an additional 10,000 to Senior Vice President David Potts are particularly suspicious, as these option were priced *near the lowest closing price for SafeNet's stock in all of 2004* and because the Company's stock price rose significantly over the following weeks. SafeNet's July 28, 2004 grant of 100,000 options to Defendant Mueller also appears particularly suspicious because it came immediately prior to SafeNet's second quarter 2004 earnings release, which was very favorable and which drove SafeNet's stock price up 26% from the July 28 closing price (and exercise price for Mueller's options) of \$22.19 to a July 29 closing price of \$27.96.

58. **2005 Option Grants:** The following chart shows the amounts and exercise prices of SafeNet's stock option grants during fiscal year 2005.

Executive Name	Title	# Securities Underlying Options Granted	% of Total Options Granted to Employees in Fiscal 2005	Exercise Price Per Share	Grant Date
Anthony A. Caputo	CEO	100,000	7.90	29.7	9/29/2005
Carole D. Argo	President COO	50,000	3.90	29.7	9/29/2005
Kenneth A. Mueller	SVP CFO	50,000	3.90	29.7	9/29/2005
Chris Fedde	SVP enterprise security	25,000	1.95	29.7	9/29/2005
Steve Lesem	SVP worldwide sales	100,000	7.90	31.78	6/1/2005
		15,000	1.20	29.7	9/29/2005
Shelley A. Harrison	Director, Consultant	25,000	3.90	29.7	9/29/2005

59. The following graph, combined with Defendants’ recent disclosures, illustrates that SafeNet’s 2005 stock option grants were suspiciously timed, in that the grants immediately or almost immediately preceded marked increases on SafeNet’s stock price.



60. In light of Defendants’ recent disclosures, SafeNet’s grants of options on September 29, 2005 are particularly suspicious for the following reasons: On September 29, 2005, SafeNet announced a \$150 million contract with the Department of Defense to deliver its new KIV-7M link encryptor (the “KIV-7M Contract”). During the public conference call disclosing this new contract (the “September 29 Call”), Defendants Caputo and Mueller touted

the benefits of the KIV-7M Contract with, Mr. Caputo stating as follows:

*Today we have announced that SafeNet has been awarded a \$150 million indefinite delivery, indefinite quantity contract by the U.S. Government's Department of Defense for our new KIV-7M top-secret grade Encryptor. We're also enthusiastically announcing that we have received the first delivery order against this contract. The delivery order valued at about \$18 million is now in our backlog.... And based on this firm backlog and a generally positive view across our business, we are today reaffirming our full year guidance for 2005.*

... [W]e're thrilled to be able to announce this contract. And we want to share its significance with you.... *[I]t's obviously the largest contract in our Company history. And it's three times larger than we were comfortable in talking about in terms of our expectations....* We're also excited about the fact that this first order, and we do believe it's the first of what will be several of these orders. This order at \$150 million represents approximately ½ of our six-year forecast for the Link Encryptor version of this product.

.... And then finally, one other thing that I would like to tell you about, though we cannot be specific with numbers here, although this contract was very, very large, as I mentioned, three times our expectation. *The unit pricing and hence the margins on this product are much better than previous KIV-7M products. And as a result, we can look forward to improving margins as we go forward.* (Emphases added).

61. In reaction to SafeNet's disclosure of the KIV-7M Contract, the market sent SafeNet stock soaring 22%, from \$29.70 per share on September 29, 2005 to \$36.31 per share by September 30, 2005, on volume of 5,010,800 shares traded, which was more than 13 times the average daily volume during the period from July 1, 2005 through September 29, 2005.

### C. The Truth Begins to Emerge About SafeNet's Options Grant Practices

62. Investors were stunned and class members injured as a result of SafeNet's disclosure on May 18, 2006. That day, SafeNet disclosed as follows:

SafeNet ... today announced that it received a subpoena from the office of the United States Attorney for the Southern District of New York relating to the Company's granting of stock options. The Company also announced that it has received an informal inquiry from the Securities and Exchange Commission requesting information relating to stock option grants to directors and officers of the Company, as well as information relating to certain accounting policies and practices.

63. As a result of the Company's disclosures, investors now were able to recognize

that the pattern of favorable option grants and Defendants' disclosures regarding those grants indicated something that went beyond good luck, but actually were the result of improper administration of the option granting process. Moreover, the fact that the Company would be investigated for using the options granting process to wrongfully line its executives' pockets with illicit gains was an entirely foreseeable consequence of Defendants' fraud. Investors punished SafeNet's stock price on the news of the multiple investigations into the Company's stock option practices (as well as the SEC's accounting inquiry), sending the stock price spiraling downward by 21%, from \$19.21 on May 18, to \$14.93 on May 19, 2006.

64. SafeNet confirmed the correctness of the investing public's negative reaction, as evidenced by the May 18 stock decline. On July 26, 2006, SafeNet issued a press release containing its earnings for the second quarter of 2006 and disclosing that it would restate, *at the least*, its fourth quarter 2002 earnings because of improper accounting and recording of prior stock option grants to executives. Defendants disclosed as follows:

#### **Update on Stock Option Granting Issues**

As previously disclosed on June 2, 2006, SafeNet's Board of Directors has appointed a special committee of the board to investigate the Company's stock option granting practices. The special committee has retained independent counsel and forensic accountants to assist in its investigation, which is currently in progress. In addition, the Company has retained an international professional services firm to assist the Company in a review of the Company's accounting for stock option grants. That review is also ongoing.

Based on its review to date, *the Company believes that certain option grants, including grants to directors, officers and employees, were or likely were accounted for using incorrect measurement dates under applicable accounting rules in effect at the time. With respect to one of these grants, made to officers and employees of the Company, including the chief executive officer, in the fourth quarter of 2002, the Company has concluded that material non-cash, stock-based compensation expenses related to this option grant will have to be recorded. Therefore, the Company expects that financial statements for the fourth quarter of 2002 will have to be restated.* As a result, the Company, in consultation with the Audit Committee and with the concurrence of its independent registered accounting



firm, Ernst & Young LLP has determined that its financial statements and its related audit report of its independent registered accounting firm for the year ended December 31, 2002 should no longer be relied upon. The review by the Company and the investigation by the special committee of the Board of Directors are not yet complete, and accordingly the Company has not yet determined if there are further charges pertaining to the 2002 period or if financial statements from any other reporting periods will require restatement. Because the Company will not file its Form 10-Q for the quarter ended June 30, 2006 until it completes its review of accounting for stock option grants, the Company will not file its Form 10-Q for the second quarter of 2006 on a timely basis.

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65. As further detailed below, because the stock options issued during the Class Period were actually the result of either backdating or spring-loading, depending on the particular grant, SafeNet's made material misrepresentations in the following publicly filed documents: (1) SafeNet's Proxy Statements for the years 2003 through 2005, (2) SafeNet's 2003 Registration Statement, and (3) SafeNet's Form 10-Ks and Form 10-Qs throughout the Class Period.

66. Specifically, whether: (1) the options issued to executives during the Class Period and listed above were actually granted *after* the dates indicated by SafeNet's prior public filings but were backdated to have exercise prices equal to the closing prices on the supposed grant dates, *or* (2) the options at issue were actually spring-loaded, *i.e.*, they were granted on the dates indicated by SafeNet's public filings but were timed so as to allow executives to wrongfully benefit from material nonpublic information – including, in particular, the July 28, 2004 options grant immediately before the highly positive second quarter 2004 earnings conference call and the September 29, 2005 grants immediately before the September 29 Call – Defendants are liable for, among others, the following material misstatements contained in various of Defendants' public filings during the Class Period:

a. The Company stated that options were granted at prices not less than the fair

market value on the date of the grant even though in fact they were often (as a result of backdating) granted at prices well below the market price on the date of the grant;

b. The Company was required under GAAP, including APB 25, to recognize the difference in value as an expense on its financial statements yet it failed to do so;

c. By not recording appropriate compensation expense, SafeNet may incur significant income-tax consequences, which its public financials did not disclose;

d. Defendants claimed that the value of the Company's stock option grants was tied to the Company's performance and stock options were granted in a manner that aligned executives' interests with those of SafeNet's shareholders, when in fact, executives were being granted stock options that included profits and benefits that investors could never enjoy and that came at the detriment of the Company and the investing public;

e. The Company's internal financial, accounting and disclosure controls were adequately designed and functioning in a manner so as to prevent fraud or manipulation.

f. SafeNet's financial reports and statements fairly presented its financial condition and results in accordance with GAAP.

g. SafeNet's stock option plans had been voted for and adopted by its Board and its shareholders and, therefore, the option shares were validly issued and would not dilute existing stockholders' ownership stake in SafeNet.

### **COUNT I**

#### **AGAINST SAFENET AND THE DIRECTOR DEFENDANTS FOR MISLEADING STATEMENTS CONTAINED IN SAFENET'S PROXY STATEMENTS FOR THE YEARS 2003 THROUGH 2005 IN VIOLATION OF SECTION 14(a) OF THE EXCHANGE ACT AND RULE 14A-9 PROMULGATED THEREUNDER**

67. This Count is brought pursuant to Section 14(a) of the Exchange Act, on behalf of

all Class members who were shareholders of SafeNet common stock at the time of the Proxy Statements for the years 2003 through 2005. This claim is not based on and does not sound in fraud. Plaintiff repeats and realleges each and every allegation above as if set forth fully herein, except any allegations of fraud, which are not necessary to assert this claim for relief.

68. Plaintiff hereby incorporates by reference and realleges each and every allegation set forth above, as though fully set forth herein, except any allegations of fraud or intent, which is not necessary to assert this Claim for Relief.

69. In soliciting shareholder approval for various amendments to the Stock Option Plan and as part of the annual proxy solicitation process, SafeNet and the Director Defendants (collectively, the "Proxy Statement Defendants") made numerous material misstatements in SafeNet's Proxy Statements during the Class Period in violation of Section 14(a) of the Exchange Act.

70. **The 2003 Proxy Statement:** Shortly after the start of the Class Period, on April 30, 2003, SafeNet and the Director Defendants who were directors of SafeNet at the time issued to investors SafeNet's definitive proxy statement on Form 14A in connection with the Company's 2003 annual meeting (the "2003 Proxy Statement"). Among other things, the 2003 Proxy Statement solicited investors to increase the number of shares in the Stock Plan from 1,600,000 to 2,100,000 shares, as follows:

The Company's stockholders approved the 2001 Omnibus Stock Plan (the "2001 Plan") on May 16, 2001. *The 2001 Plan is intended to provide employees and directors with an incentive to actively contribute to the Company's growth by enabling them to acquire a proprietary interest in the Company.* The Company's stockholders approved a proposal at the 2002 annual meeting of stockholders to increase the maximum shares available for awards under the 2001 Plan from 1,000,000 to 1,600,000.

We are proposing that the shareholders approve an additional 500,000 shares that may be sold or optioned under the 2001 Plan. (emphasis added.)

71. The 2003 Proxy Statement made the following material misstatements regarding the Company's stock option grants and granting practices:

a. Under the heading "Executive Compensation," Defendants provided a chart listing "Options Grants in Fiscal Year 2002." Footnote 4 to this chart stated as follows:

The potential realizable value has been calculated in conformity with Security and Exchange Commission proxy statement disclosure rules and is not intended to forecast possible future appreciation of the Common Stock. ***No gain to the options is possible without stock price appreciation, which will benefit all shareholders. If the stock price does not increase above the exercise price, compensation to the named executive will be zero.***

b. Under the heading "Report of Compensation Committee on Executive Compensation," Defendants disclosed the following:

The Compensation Committee of the Board of Directors (the "Committee") establishes the general compensation policies of the Company, specific compensation for each executive officer of the Company and administers the Company's stock plans. ***The Company's intent as administered through the Committee is ... to provide effective incentives*** to motivate and reward such executives for achieving the scientific, financial and strategic goals of the Company essential to the Company's long-term success and to growth in stockholder value. Consequently, a significant portion of the compensation of the executive officers and directors ***is dependent on the Common Stock price performance and maintenance of value in the marketplace.***

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***Grants of stock options are designed to align the executive's interest with that of the stockholders of the Company.*** (emphases added.)

c. Under the heading "Potential Limitations on Company Deductions," Defendants disclosed as follows:

Section 162(m) of the Code denies a deduction to any publicly held corporation for compensation paid to certain "covered employees" in a taxable year to the extent that compensation to such covered employee exceeds \$1 million. It is possible that compensation attributable to awards, when combined with all other types of compensation received by a covered employee from the Company, may cause this limitation to be exceeded in any particular year.

Certain kinds of compensation, including qualified "performance-based

compensation,” are disregarded for purposes of the deduction limitation. In accordance with Treasury regulations issued under Section 162(m), compensation attributable to stock options and stock appreciation rights will qualify as performance-based compensation if the award is granted by a compensation committee comprised solely of “outside directors” and either (i) the plan contains a per-employee limitation on the number of shares for which such awards may be granted during a specified period, the per-employee limitation is approved by the stockholders *and the exercise price of the award is no less than the fair market value of the stock on the date of grant*, or (ii) *the award is granted (or exercisable) only upon the achievement (as certified in writing by the compensation committee) of an objective performance goal established in writing by the compensation committee while the outcome is substantially uncertain*, and the award is approved by stockholders. *It is intended that stock options issued under the 2001 Plan will qualify as “performance-based compensation.”* (emphasis added.)

72. As set forth above, during 2002, SafeNet issued stock options to certain executives that were either backdated or spring-loaded. As a result, the 2003 Proxy Statement was materially misstated because, contrary to Defendants’ public disclosures:

a. To the extent stock options were “backdated,” the Individual Defendants who received those backdated stock options in 2002 were able to enjoy gain without stock price appreciation following the grant of the options because the options were secretly issued at prices below fair market value;

b. Contrary to Defendants’ public disclosures, SafeNet in fact did issue options that were “backdated,” so the “per share option price” was *not* “the closing price on the grant date,” as had been disclosed. Alternatively, during 2002, SafeNet issued stock options to executives immediately prior to the disclosure of material positive news, such that the executives were taking advantage of material nonpublic information at the expense of shareholders;

c. Defendants materially misstated their compensation policies because, with respect to the stock option grants that were either “backdated” or “spring-loaded,” those grants *did not* “align the executive’s interest with that of the stockholders of the Company” because those executives were obtaining financial benefits irrespective of any future performance or

“springing” ahead of future disclosures of known positive performance, since the option strike prices already reflected stock appreciation that preceded the grant date or reflected stock appreciation that would take place upon the disclosure of the relevant material nonpublic information; and

d. Stock options that were granted at below fair market value or based on performance goals whose outcome was no longer uncertain might not qualify as “performance-based compensation,” as Defendants asserted would be the case for options granted under the Stock Option Plan.

73. **2004 Proxy Statement:** On April 29, 2004, SafeNet and the Director Defendants who were directors of SafeNet at the time issued to investors SafeNet’s definitive proxy statement on Form 14A in advance of the Company’s 2004 annual meeting (the “2004 Proxy Statement”). The 2004 Proxy Statement made the following material misstatements regarding the Company’s stock option grants and granting practices:

a. Under the heading “Executive Compensation,” Defendants provided a chart listing “Options Grants in Fiscal Year 2003.” Footnote 4 to this chart stated as follows:

The potential realizable value has been calculated in conformity with Securities and Exchange Commission proxy statement disclosure rules and is not intended to forecast possible future appreciation of the Common Stock. ***No gain to the options is possible without stock price appreciation, which will benefit all shareholders. If the stock price does not increase above the exercise price, compensation to the named executive will be zero.***

b. Under the heading “Report of Compensation Committee on Executive Compensation,” Defendants disclosed the following:

The Compensation Committee of the Board of Directors (the “Committee”) establishes the general compensation policies of the Company, specific compensation for each executive officer of the Company and administers the Company’s stock plans. ***The Company’s intent as administered through the Committee is ... to provide effective incentives*** to motivate and reward such

executives for achieving the scientific, financial and strategic goals of the Company essential to the Company's long-term success and to growth in stockholder value. Consequently, a significant portion of the compensation of the executive officers and directors *is dependent on the Common Stock price performance and maintenance of value in the marketplace.*

\*\*\*\*\*

*Grants of stock options are designed to align the executive's interest with that of the stockholders of the Company.* (emphases added.)

74. As set forth above, during 2003, SafeNet issued stock options to certain of the Individual Defendants that were either backdated or spring-loaded. As a result, the 2004 Proxy Statement was materially misstated because, contrary to Defendants' public disclosures:

a. To the extent stock options were "backdated," the Individual Defendants who received those backdated stock options in 2003 were able to enjoy gain without stock price appreciation following the grant of the options because the options were secretly issued at prices below fair market value;

b. Contrary to Defendants' public disclosures, SafeNet in fact did issue options that were "backdated," so the "per share option price" was *not* "the closing price on the grant date," as had been disclosed. Alternatively, during 2003, SafeNet issued stock options to executives immediately prior to the disclosure of material positive news, such that the executives were taking advantage of material nonpublic information at the expense of shareholders; and

c. Finally, the Defendants materially misstated SafeNet's compensation policies because, with respect to the stock option grants that were either "backdated" or "spring-loaded," those grants *did not* "align the executive's interest with that of the stockholders of the Company" because those executives were obtaining financial benefits irrespective of any future performance or "springing" ahead of future disclosures of positive news, since the option strike prices already reflected stock appreciation that preceded the grant date or reflected stock

appreciation that would take place upon the disclosure of the relevant material nonpublic information.

75. **The 2005 Proxy Statement:** On July 6, 2005, SafeNet and the Defendants who were directors of SafeNet at the time issued to investors SafeNet's definitive proxy statement on Form 14A in connection with the 2005 annual meeting of shareholders (the "2005 Proxy Statement"). Among other things, the 2005 Proxy Statement solicited investors to increase the number of shares in the Stock Plan from 3,000,000 to 6,000,000 shares. The 2005 Proxy Statement made the following material misstatements regarding the Company's stock option grants and granting practices:

a. Under the heading "Executive Compensation," Defendants provided a chart listing "Options Grants in Fiscal Year 2004." Footnote 4 to this chart stated as follows:

The potential realizable value has been calculated in conformity with Securities and Exchange Commission proxy statement disclosure rules and is not intended to forecast possible future appreciation of the common stock. ***No gain to the options is possible without stock price appreciation, which will benefit all shareholders. If the stock price does not increase above the exercise price, compensation to the named executive will be zero.*** (emphasis added.)

b. Under the heading "Report of Compensation Committee on Executive Compensation," Defendants disclosed the following:

The Compensation Committee of the Board of Directors (the "Committee") reviews and approves the general compensation policies of the Company, specific compensation for each executive officer of the Company, the Company's equity compensation plans and makes recommendations to the Board of Directors regarding these matters. ***The Company's policy, as administered through the Committee, is to provide compensation packages to the executive officers of the Company sufficient to ... provide effective incentives*** to motivate and reward such executives for achieving the technical, financial and strategic goals of the Company essential to the Company's long-term success and to growth in stockholder value. Consequently, a significant portion of the compensation of the executive officers and directors ***is dependent on company performance and maintenance of value in the marketplace.***

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***Grants of stock options are designed to align the executive's interest with that of the stockholders of the Company.*** (emphases added.)

c. Under the heading “Potential Limitations on Company Deductions,” Defendants disclosed as follows:

Section 162(m) of the Code denies a deduction to any publicly held corporation for compensation paid to certain “covered employees” in a taxable year to the extent that compensation to such covered employee exceeds \$1 million. It is possible that compensation attributable to awards, when combined with all other types of compensation received by a covered employee from the Company, may cause this limitation to be exceeded in any particular year.

Certain kinds of compensation, including qualified “performance-based compensation,” are disregarded for purposes of the deduction limitation. In accordance with Treasury regulations issued under Section 162(m), compensation attributable to stock options and stock appreciation rights will qualify as performance-based compensation if the award is granted by a compensation committee comprised solely of “outside directors” and either (i) the plan contains a per-employee limitation on the number of shares for which such awards may be granted during a specified period, the per-employee limitation is approved by the stockholders and the exercise price of the award is ***no less than the fair market value of the stock on the date of grant***, or (ii) ***the award is granted (or exercisable) only upon the achievement (as certified in writing by the compensation committee) of an objective performance goal established in writing by the compensation committee while the outcome is substantially uncertain***, and the award is approved by stockholders. ***It is intended that stock options issued under the 2001 Plan will qualify as “performance-based compensation.”*** (emphases added.)

76. As set forth above, during 2004, SafeNet issued stock options to certain of the Individual Defendants that were either backdated or spring-loaded. As a result, the 2005 Proxy Statement was materially misstated because, contrary to Defendants’ public disclosures:

a. To the extent stock options were “backdated,” the Individual Defendants who received those backdated stock options in 2004 were able to enjoy gain without stock price appreciation following the grant of the options because the options were secretly issued at prices below fair market value;

b. Contrary to Defendants’ public disclosures, SafeNet in fact did issue options that

were “backdated,” so the “per share option price” was *not* “the closing price on the grant date,” as had been disclosed. Alternatively, during 2004, SafeNet issued stock options to executives immediately prior to the disclosure of material positive news, such that the executives were taking advantage of material nonpublic information at the expense of shareholders;

c. Defendants materially misstated their compensation policies because, with respect to the stock option grants that were either “backdated” or “spring-loaded,” those grants *did not* “align the executive’s interest with that of the stockholders of the Company” because those executives were obtaining financial benefits irrespective of any future performance or “springing” ahead of future disclosures of positive performance, since the option strike prices already reflected stock appreciation that preceded the grant date or reflected stock appreciation that would take place upon the disclosure of the relevant material nonpublic information; and

d. Stock options that were granted at below fair market value or based on performance goals whose outcome was no longer uncertain might not qualify as “performance-based compensation,” as Defendants asserted would be the case for options granted under the Stock Option Plan.

77. Rule 14a-9, promulgated pursuant to Section 14(a) of the Exchange Act provides that no proxy statement shall contain “any statement which, at the time and in the light of the circumstances under which it made, is false or misleading with respect to any material fact, or which omits to state any material fact necessary in order to make the statements therein not false or misleading.” 17 C.F.R. § 240.14a-9.

78. SafeNet’s Proxy Statements for the years 2003 through 2005 violated Section 14(a) and Rule 14a-9 because they omitted material facts, including the fact that SafeNet was improper backdating and/or spring-loading as part of its stock option granting practices.

79. In the exercise of reasonable care, Defendants should have known that SafeNet's Proxy Statements for the years 2003 through 2005 were materially misleading.

80. The misrepresentations and omissions in the 2003 through 2005 Proxy Statements were material to plaintiff and to other SafeNet investors in voting on each Proxy Statement. The 2003 through 2005 Proxy Statements were an essential link in the accomplishment of the continuation of Defendants' unlawful stock option administration, as revelations of the truth would have immediately thwarted a continuation of shareholders' endorsement of the directors' positions, the executive officers' compensation and the Company's compensation policies, including the 2003 and 2005 amendments to expand the number of shares authorized under the Stock Option Plan.

81. SafeNet shareholders were damaged as a result of the material misrepresentations and omissions in the 2003 through 2005 Proxy Statements and are therefore entitled to equitable relief and compensatory damages.

## **COUNT II**

### **FOR STOCK OPTION-RELATED MISREPRESENTATIONS IN VIOLATION OF SECTION 10(b) OF THE EXCHANGE ACT AND RULE 10B-5 PROMULGATED THEREUNDER AGAINST SAFENET, THE OFFICER DEFENDANTS AND THE COMPENSATION COMMITTEE DEFENDANTS**

82. Plaintiff repeats and realleges each and every allegation above as if set forth fully herein. Plaintiff asserts this count against the Defendants listed above on the following basis:

- a. against SafeNet and Defendant Caputo as to each misleading statement listed below as well as the misleading statements identified in Count I above;
- b. against Defendant Argo as to each Form 10-K and Form 10-Q that she signed;

- c. against Defendant Mueller as to each Form 10-K and Form 10-Q that he signed;
- d. against Compensation Committee Defendant Brooks as to each Form 10-K issued during the Class Period as well as the misleading statements identified in Count I above;
- e. against Compensation Committee Defendant Hunt as to each Form 10-K issued during the Class Period as well as the misleading statements identified in Count I above;
- f. against Compensation Committee Defendant Thaw as to each Form 10-K issued during the Class Period as well as the misleading statements identified in Count I above;
- g. against Compensation Committee Defendant Money as to the Form 10-K issued for the years ended December 31, 2004 and December 31, 2005 as well as the false and misleading statements from the 2004 and 2005 Proxy Statements identified in Count I above.

**D. Defendants' Materially False and Misleading Disclosures Regarding SafeNet Stock Option Grants**

83. On March 31, 2003, SafeNet filed with the SEC its Form 10-K for the year ended December 31, 2002 (the "2002 Form 10-K"). Officer Defendants Caputo and Argo and Director Defendants Brooks, Harrison, Hunt and Thaw signed the 2002 Form 10-K. The 2002 Form 10-K made the following disclosures pertinent to executive compensation and the granting of stock options:

- a. Note 2 to SafeNet's financial statements for 2002, as disclosed in the 2002 Form 10-K, was entitled "Summary of Significant Accounting Policies." Regarding compensation, Note 2 disclosed as follows:

**Employee Stock-Based Compensation**

At December 31, 2002, the Company had five stock-based employee compensation plans, which are described more fully in Note 12. The Company accounts for those plans using the intrinsic value method prescribed by APB Opinion No. 25, *Accounting for Stock Issued to Employees*, and related Interpretations. ***No stock-based employee compensation cost is reflected in net income, as all options granted***

*under those plans had an exercise price equal to the market value of the underlying common stock on the date of grant.* (emphasis added.)

b. Note 12 to the financial statements for 2002, as disclosed in the 2002 Form 10-K, was entitled “Stock Compensation Plans,” and stated as follows:

**Stock Option Plans**

The Company sponsors four stock option plans that provide for the granting of stock options to officers, directors, consultants and employees of the Company. *Options have been granted with exercise prices that are equal to the fair market value of the common stock on the date of grant* and, subject to termination of employment, expire seven years from the date of grant. Either incentive stock options or non-qualified stock options may be granted under the plans. (emphasis added.)

84. The 2002 Form 10-K was materially false and misleading when issued because, contrary to Defendants’ public disclosures, SafeNet in fact did issue options that were “backdated,” so they were not issued at exercise prices “equal to the fair market value of the common stock on the date of grant,” as had been disclosed. Alternatively, during 2002, SafeNet issued stock options to executives immediately prior to the disclosure of material positive news, such that the executives were taking advantage of material nonpublic information at the expense of shareholders.

85. On May 15, 2003, SafeNet filed with the SEC its Form 10-Q for the first quarter of 2003 (the “1Q 2003 Form 10-Q”). Defendants Caputo and Argo signed the 1Q 2003 Form 10-Q. Note 2 to SafeNet’s financial statements for the first quarter of 2003, as disclosed in the 1Q 2003 Form 10-Q, was entitled “Significant Accounting Policies and Recent Accounting Pronouncements.” Under the heading “Stock Options and Stock Granted to Employees,” Note 2 disclosed as follows:

The Company records compensation expense for all stock-based compensation plans using the intrinsic value method prescribed by APB Opinion No. 25, *Accounting for Stock Issued to Employees* (“APB No. 25”). Under APB No. 25, compensation expense is recorded over the vesting period to the extent that the fair value of the

underlying stock on the date of grant exceeds the exercise or acquisition price of the stock or stock-based award....

At March 31, 2003, the Company has five stock-based employee compensation plans. *All options granted under those plans had an exercise price equal to the market value of the underlying common stock on the date of grant.* (emphasis added.)

86. As set forth above, during 2003, SafeNet issued stock options that were backdated or spring-loaded. The 1Q 2003 Form 10-Q was materially false and misleading when issued because stock options that were backdated were not, as publicly disclosed, granted with “an exercise price equal to the market value of the underlying common stock on the date of grant.” Alternatively, stock options that were “spring-loaded” were also not granted with “an exercise price equal to the market value of the underlying common stock on the date of grant” because those options were granted while the recipients of those options possessed material nonpublic information and therefore knew that SafeNet’s market price was understated relative to its fair value.

87. On July 31, 2003, SafeNet filed with the SEC its Form 10-Q for the second quarter of 2003 (the “2Q 2003 Form 10-Q”). Defendants Caputo and Argo signed the 2Q 2003 Form 10-Q. Note 2 to SafeNet’s financial statements for the second quarter of 2003, as disclosed in the 2Q 2003 Form 10-Q, was entitled “Significant Accounting Policies and Recent Accounting Pronouncements.” Under the heading “Stock Options and Stock Granted to Employees,” Note 2 disclosed as follows:

The Company records compensation expense for all stock-based compensation plans using the intrinsic value method prescribed by APB Opinion No. 25, *Accounting for Stock Issued to Employees* (“APB No. 25”). Under APB No. 25, compensation expense is recorded over the vesting period to the extent that the fair value of the underlying stock on the date of grant exceeds the exercise or acquisition price of the stock or stock-based award....

At June 30, 2003, the Company has seven stock-based employee compensation

plans. *All options granted under those plans had an exercise price equal to the market value of the underlying common stock on the date of grant.* (emphasis added.)

88. As set forth above, during 2003, SafeNet issued stock options that were backdated or spring-loaded. The 2Q 2003 Form 10-Q was materially false and misleading when issued because stock options that were backdated were not, as publicly disclosed, granted with “an exercise price equal to the market value of the underlying common stock on the date of grant.” Alternatively, stock options that were “spring-loaded” were also not granted with “an exercise price equal to the market value of the underlying common stock on the date of grant” because those options were granted while the recipients of those options possessed material nonpublic information and therefore knew that SafeNet’s market price was understated relative to its fair value.

89. On November 14, 2003, SafeNet filed with the SEC its Form 10-Q for the third quarter of 2003 (the “3Q 2003 Form 10-Q”). Defendants Caputo and Argo signed the 3Q 2003 Form 10-Q. Note 2 to SafeNet’s financial statements for the third quarter of 2003, as disclosed in the 3Q 2003 Form 10-Q, was entitled “Significant Accounting Policies and Recent Accounting Pronouncements.” Under the heading “Stock Options and Stock Granted to Employees,” Note 2 disclosed as follows:

The Company records compensation expense for all stock-based compensation plans using the intrinsic value method prescribed by APB Opinion No. 25, *Accounting for Stock Issued to Employees* (“APB No. 25”). Under APB No. 25, compensation expense is recorded over the vesting period to the extent that the fair value of the underlying stock on the date of grant exceeds the exercise or acquisition price of the stock or stock-based award....

At September 30, 2003, the Company has seven stock-based employee compensation plans. *All options granted under those plans had an exercise price equal to the market value of the underlying common stock on the date of grant.* (emphasis added.)

90. As set forth above, during 2003, SafeNet issued stock options that were backdated or spring-loaded. The 3Q 2003 Form 10-Q was materially false and misleading when issued because stock options that were backdated were not, as publicly disclosed, granted with “an exercise price equal to the market value of the underlying common stock on the date of grant.” Alternatively, stock options that were “spring-loaded” were also not granted with “an exercise price equal to the market value of the underlying common stock on the date of grant” because those options were granted while the recipients of those options possessed material nonpublic information and therefore knew that SafeNet’s market price was understated relative to its fair value.

91. On March 10, 2004, SafeNet filed with the SEC its Form 10-K for the year ended December 31, 2003 (the “2003 Form 10-K”). Officer Defendants Caputo and Argo and Director Defendants Brooks, Harrison, Hunt and Thaw signed the 2003 Form 10-K. The 2003 Form 10-K made the following disclosures pertinent to executive compensation and the granting of stock options:

a. Note 2 to SafeNet’s financial statements for 2003, as disclosed in the 2003 Form 10-K, was entitled “Summary of Significant Accounting Policies.” Regarding compensation, Note 2 disclosed as follows:

**Employee Stock-Based Compensation**

At December 31, 2003, the Company had five stock-based employee compensation plans, which are described more fully in Note 12. The Company accounts for those plans using the intrinsic value method prescribed by APB Opinion No. 25, *Accounting for Stock Issued to Employees*, and related interpretations. *No stock-based employee compensation cost is reflected in the statements of operations, as all options granted under those plans had an exercise price equal to the market value of the underlying common stock on the date of grant.* (emphasis added.)

b. Note 12 to the financial statements for 2003, as disclosed in the 2003 Form 10-K,



was entitled “Stock Compensation Plans and Warrants,” and stated as follows:

### **Stock Option Plans**

The Company sponsors five stock option plans that provide for the granting of stock options to officers, directors, consultants and employees of the Company. *Options have been granted with exercise prices that are equal to the fair market value of the common stock on the date of grant* and, subject to termination of employment, expire seven years from the date of grant. Either incentive stock options or non-qualified stock options may be granted under the plans. (emphasis added.)

92. The 2003 Form 10-K was materially false and misleading when issued because, contrary to Defendants’ public disclosures, SafeNet in fact did issue options that were “backdated,” so they were not issued at exercise prices “equal to the fair market value of the common stock on the date of grant,” as had been disclosed. Alternatively, during 2003, SafeNet issued stock options to executives immediately prior to the disclosure of material positive news, such that the executives were taking advantage of material nonpublic information at the expense of shareholders.

93. The Company did not grant stock options to executives during the first quarter of 2004. On August 9, 2004, SafeNet filed with the SEC its Form 10-Q for the second quarter of 2004 (the “2Q 2004 Form 10-Q”). Defendants Caputo and Mueller signed the 2Q 2004 Form 10-Q. Note 3 to SafeNet’s financial statements for the second quarter of 2004, as disclosed in the 2Q 2004 Form 10-Q, was entitled “Summary of Significant Accounting Policies.” Under the heading “Employee Stock-Based Compensation,” Note 3 disclosed as follows:

As of June 30, 2004, the Company had five stock-based employee compensation plans. The Company accounts for those plans using the intrinsic value method prescribed by APB Opinion No. 25, *Accounting for Stock Issued to Employees*, and related interpretations. Compensation cost is reflected in the statements of operations, in general and administrative costs.

94. As set forth above, during the second quarter of 2004, SafeNet issued stock options that were backdated or spring-loaded. The 2Q 2004 Form 10-Q was materially false and

misleading when issued because it failed to disclose the fact that or the manner in which those stock options were backdated or “spring-loaded.”

95. On November 9, 2004, SafeNet filed with the SEC its Form 10-Q for the third quarter of 2004 (the “3Q 2004 Form 10-Q”). Defendants Caputo and Mueller signed the 3Q 2004 Form 10-Q. Note 3 to SafeNet’s financial statements for the second quarter of 2004, as disclosed in the 2Q 2004 Form 10-Q, was entitled “Summary of Significant Accounting Policies.” Under the heading “Employee Stock-Based Compensation,” Note 3 disclosed as follows:

As of September 30, 2004, the Company had five stock-based employee compensation plans. The Company accounts for those plans using the intrinsic value method prescribed by APB Opinion No. 25, *Accounting for Stock Issued to Employees*, and related interpretations.

96. As set forth above, during 2004, SafeNet issued stock options that were backdated or spring-loaded. The 3Q 2004 Form 10-Q was false and misleading because it failed to disclose the fact that or the manner in which the stock options were backdated or “spring-loaded.”

97. On March 16, 2005, SafeNet filed with the SEC its Form 10-K for the year ended December 31, 2004 (the “2004 Form 10-K”). Officer Defendants Caputo and Mueller and Director Defendants Brooks, Harrison, Hunt, Thaw, Clark, Straub and Money signed the 2004 Form 10-K. The 2004 Form 10-K made the following disclosures pertinent to executive compensation and the granting of stock options:

a. Note 2 to SafeNet’s financial statements for 2004, as disclosed in the 2004 Form 10-K, was entitled “Summary of Significant Accounting Policies.” Regarding compensation, Note 2 disclosed as follows:

**Employee Stock-Based Compensation**

At December 31, 2004, the Company had five stock-based employee compensation

plans, which are described more fully in Note 12. The Company accounts for those plans using the intrinsic value method prescribed by APB Opinion No. 25, *Accounting for Stock Issued to Employees*, and related interpretations. With the exception of unvested stock options assumed in business combinations, ***no stock-based employee compensation cost is reflected in the statements of operations, as all options granted under those plans had an exercise price equal to the market value of the underlying common stock on the date of grant.*** (emphasis added.)

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### **Recent Accounting Pronouncements**

On December 16, 2004, the Financial Accounting Standards Board (“FASB”) issued FASB Statement No. 123 (revised 2004), *Share-Based Payment*, which is a revision of FASB Statement No. 123, *Accounting for Stock-Based Compensation*. Statement 123(R) supersedes APB Opinion No. 25, *Accounting for Stock Issued to Employees*, and amends FASB Statement No. 95, *Statement of Cash Flows*. Generally, the approach in Statement 123(R) is similar to the approach described in Statement 123. However, Statement 123(R) requires all share-based payments to employees, including grants of employee stock options, to be recognized in the income statement based on their fair values. Pro forma disclosure is no longer an alternative. The Company expects to adopt Statement 123(R) on July 1, 2005.

***As permitted by Statement 123, the Company currently accounts for share-based payments to employees using Opinion 25’s intrinsic value method and, as such, generally recognizes no compensation cost for employee stock options.*** (emphasis added.)

b. Note 13 to the financial statements for 2004, as disclosed in the 2004 Form 10-K, was entitled “Stock Compensation Plans,” and stated as follows:

### **Stock Option Plans**

The Company sponsors five stock option plans that provide for the granting of stock options to officers, directors, consultants and employees of the Company. ***Options have been granted with exercise prices that are equal to the fair market value of the common stock on the date of grant*** and, subject to termination of employment, expire seven years from the date of grant. Either incentive stock options or non-qualified stock options may be granted under the plans. (emphasis added.)

98. As set forth above, the 2004 Form 10-K was materially false and misleading when issued because, contrary to Defendants’ public disclosures, SafeNet in fact did issue options that were “backdated,” so they were not issued at exercise prices “equal to the fair

market value of the common stock on the date of grant,” as had been disclosed. Alternatively, during 2004, SafeNet issued stock options to executives immediately prior to the disclosure of material positive news, such that the executives were taking advantage of material nonpublic information at the expense of shareholders.

99. On April 29, 2005, SafeNet filed with the SEC an amendment to the 2004 Form 10-K, filed as Form 10-K/A (the “2004 Form 10-K/A”). Officer Defendants Caputo and Mueller and Director Defendants Brooks, Harrison, Hunt, Thaw, Clark, Straub and Money signed the 2004 Form 10-K/A. The 2004 Form 10-K/A made the following disclosures pertinent to compensation and stock option grants:

a. Item 11 of the 2004 Form 10-K/A, entitled “Executive Compensation,” included a chart showing the option grants in 2004 to Senior Vice Presidents Fedde and Potts and to Defendants Caputo, Argo and Mueller. Footnote 4 to this chart stated as follows:

The potential realizable value has been calculated in conformity with Securities and Exchange Commission proxy statement disclosure rules and is not intended to forecast possible future appreciation of the common stock. ***No gain to the options is possible without stock price appreciation, which will benefit all shareholders. If the stock price does not increase above the exercise price, compensation to the named executive will be zero.*** (emphasis added.)

b. Item 11 also included disclosure pertaining to the compensation of directors, and stated as follows:

After each annual meeting of stockholders, each non-employee director of the Company who attended at least 75% of the aggregate number of meetings of the Board during the previous calendar year and who stood for election at the preceding annual meeting is granted a stock option exercisable for 20,000 shares of common stock. ***The per share option price is the closing price on the grant date.*** The option has a ten-year term and is fully vested on the grant date. (emphasis added.)

c. Item 11 also included the following disclosure under the heading “Report of Compensation Committee on Executive Compensation”:

*The Compensation Committee of the Board of Directors (the “Committee”) reviews and approves the general compensation policies of the Company, specific compensation for each executive officer of the Company, the Company’s equity compensation plans and makes recommendations to the Board of Directors regarding these matters. The Company’s policy, as administered through the Committee, is ... to provide effective incentives to motivate and reward such executives for achieving the technical, financial and strategic goals of the Company essential to the Company’s long-term success and to growth in stockholder value. Consequently, a significant portion of the compensation of the executive officers and directors is dependent on company performance and maintenance of value in the marketplace.*

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*Grants of stock options are designed to align the executive’s interest with that of the stockholders of the Company.* (emphases added.)

100. As shown above, during 2004, SafeNet issued stock options to certain executives that were either backdated or spring-loaded. As a result, the 2004 Form 10-K/A was materially false and misleading when issued because, contrary to Defendants’ public disclosures:

a. To the extent stock options were “backdated,” the Individual Defendants who received those backdated stock options in 2004 were able to enjoy gain without stock price appreciation following the grant of the options because the options were secretly issued at prices below fair market value;

b. Contrary to Defendants’ public disclosures, SafeNet in fact did issue options that were “backdated,” so the “per share option price” was *not* “the closing price on the grant date,” as had been disclosed. Alternatively, during 2004, SafeNet issued stock options to executives immediately prior to the disclosure of material positive news, such that the executives were taking advantage of material nonpublic information at the expense of shareholders; and

c. Finally, the Defendants falsely described SafeNet’s compensation policies because, with respect to the stock option grants that were either “backdated” or “spring-loaded,” those grants *did not* “align the executive’s interest with that of the stockholders of the Company”

because those executives were obtaining financial benefits irrespective of any future performance, since the option strike prices already reflected stock appreciation that preceded the grant date or reflected stock appreciation that would take place upon the disclosure of the relevant material nonpublic information.

101. SafeNet did not issue stock options to executives during the first quarter of 2005. On a Form 8-K dated July 26, 2005 and signed by Defendant Caputo, SafeNet informed the market that it had amended the Company's 2001 Omnibus Stock Option Plan with shareholder approval in several material respects. Of particular import, the amended plan provided that all stock options granted under the Plan ***must have an exercise price of not less than the fair market value of the Company's common stock as of the date of grant.***

102. The Form 8-K dated July 26, 2005 was materially false and misleading because Defendants failed to disclose that despite prior representations to the contrary (as identified above) since at least 2002, SafeNet had already granted millions of dollars worth of stock options with exercise prices less than fair market value.

103. On November 9, 2005, SafeNet filed with the SEC its Form 10-Q for the third quarter of 2005 (the "3Q 2005 Form 10-Q"). Defendants Caputo and Mueller signed the 3Q 2005 Form 10-Q. Note 3 to SafeNet's financial statements for the third quarter of 2005, as disclosed in the 3Q 2005 Form 10-Q, was entitled "Summary of Significant Accounting Policies."

a. Under the heading "Employee Stock-Based Compensation," Note 3 disclosed as follows:

As of September 30, 2005, the Company had five stock-based employee compensation plans. The Company accounts for those plans using the intrinsic value method prescribed by APB Opinion No. 25, *Accounting for Stock Issued to Employees*, and related interpretations.

b. Under the heading “Recent Accounting Pronouncements,” Note 3 disclosed as follows:

As permitted by Statement 123, the Company currently accounts for share-based payments to employees using Opinion 25’s intrinsic value method and, as such, *generally recognizes no compensation cost for employee stock options.*

104. As set forth above, during 2005, SafeNet issued stock options with exercise prices equal to the closing price on September 29, 2005, the day of the critical announcement of SafeNet’s KIV-7M Contract. Those options were either backdated or spring-loaded. The 3Q 2005 Form 10-Q was false and misleading because it failed to disclose the fact that or the manner in which the stock options were backdated or “spring-loaded.” Further, to the extent the options were backdated, the 3Q 2005 Form 10-Q falsely stated the Company “recognizes no compensation cost for employee stock options” when, in fact, it was required to do so.

105. On March 16, 2006, SafeNet filed with the SEC its Form 10-K for the year ended December 31, 2005 (the “2005 Form 10-K”). Officer Defendants Caputo and Mueller and Director Defendants Brooks, Harrison, Hunt, Thaw, Clark, Straub and Money signed the 2005 Form 10-K. The 2005 Form 10-K made the following disclosures pertinent to executive compensation and the granting of stock options:

a. Note 2 to SafeNet’s financial statements for 2005, as disclosed in the 2005 Form 10-K, was entitled “Summary of Significant Accounting Policies.” Regarding compensation, Note 2 disclosed as follows:

**Employee Stock-Based Compensation**

At December 31, 2005, the Company had five stock-based employee compensation plans, which are described more fully in Note 14. The Company accounts for those plans using the intrinsic value method prescribed by APB Opinion No. 25, *Accounting for Stock Issued to Employees*, and related interpretations. Under the intrinsic value method, stock compensation expense is defined as the difference between the amount payable upon exercise of an option and the quoted market value

of the underlying common stock on the date of grant or measurement date. Stock-based employee compensation reflected in the statements of operations includes the amortization of unearned compensation related to unvested options assumed in purchase business combinations as well as the amortization of the intrinsic value of certain options granted to employees with exercise prices below the market value of the underlying common stock on the date of grant. Any resulting compensation expense is recognized ratably over the vesting period.

b. Note 14 to the financial statements for 2005, as disclosed in the 2005 Form 10-K, was entitled “Stock Compensation Plans,” and stated as follows:

### **Stock Option Plans**

The Company sponsors five stock option plans that provide for the granting of stock options to officers, directors, consultants and employees of the Company. Options have been granted with exercise prices that are equal to, or in some cases below the fair market value of the common stock on the date of grant and, subject to termination of employment, expire seven years from the date of grant. Either incentive stock options or non-qualified stock options may be granted under the plans. The vesting and exercise periods are determined by the Board of Directors and the lives may not exceed ten years.

106. The 2005 Form 10-K was materially false and misleading and omitted to state material facts because Defendants failed to disclose the extent to which stock options had been granted in prior periods at exercise prices below the fair market value on the date of the grant (including periods when SafeNet disclosed that all option were granted with prices equal to the market price on the date of the grant), that stock options had been granted by virtue of “backdating” and that stock options had been granted while the recipient of the option was in possession of material nonpublic information as part of a “spring-loading” transaction. Further, to the extent options were issued following the July 26 Shareholder Meeting at exercise prices lower than the market prices on the date of the grant, Defendants failed to disclose that those options were granted in violation of the then-applicable version of the Stock Option Plan, which prohibited any grant of stock options at prices less than fair market value.

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107. Throughout the Class Period, the Defendants named in this Count individually and in concert, directly and indirectly, by the use and means of instrumentalities of interstate commerce and/or of the mails, engaged and participated in a continuous course of conduct to conceal material adverse information about SafeNet, including its reported financial results, financial controls and true financial condition and its improper practices with respect to the granting of stock options to the Company's senior executives, as specified herein.

108. The Defendants named in this Count employed devices, schemes, and artifices to defraud while in possession of material, adverse non-public information and engaged in acts, practices, and a course of conduct that included the making of, or participation in the making of, untrue and/or misleading statements of material facts and/or omitting to state material facts necessary in order to make the statements made about SafeNet not misleading. Specifically, Defendants initiated and pursued a scheme and course of conduct which: (i) concealed the fact that the Company was allowing insiders to manipulate its Stock Option Plan and was misrepresenting its financial results; (ii) maintained Defendants' executive and directorial positions at SafeNet and the profits, power and prestige which Defendants enjoyed as a result of these positions; (iii) deceived the investing public, including shareholders of SafeNet, regarding Defendants' compensation practices, including the granting of stock options through backdating or spring-loading, and regarding SafeNet's financial performance.

109. The Defendants named in this Count, as the directors and/or top executive officers of the Company, are liable as direct participants in the wrongs complained of herein. Through their positions of control and authority as officers and/or directors of the Company, the Individual Defendants were able to and did control the content of the public statements disseminated by SafeNet. With knowledge of or recklessness as to the falsity and/or misleading

nature of the statements contained therein and in reckless disregard of the true operations and finances of the Company, the Individual Defendants caused the heretofore complained of public statements to contain misstatements and omissions of material facts as alleged herein.

110. The Defendants named in this Count acted with scienter throughout the Class Period, in that they either had actual knowledge of the misrepresentations and/or omissions of material facts set forth herein, or acted with reckless disregard for the truth in that they failed to ascertain and to disclose the true facts, even though such facts were available to them. The Individual Defendants constituted the senior management of the Company, and were therefore directly responsible for the false and misleading statements and/or omissions disseminated to the public through press releases, news reports, and filings with the SEC.

111. The Defendants named in this Count also acted with scienter in that they took advantage of the misrepresentations made to investors in order to enrich themselves through continued receipt of backdated or spring-loaded stock options. The Compensation Committee Defendants acted with scienter in that when signing the Form 10-Ks, they either had affirmative knowledge of the stock option grants that had been backdated or spring-loaded, or they were reckless as to the truth in that they disregarded their obligations, as members of SafeNet's Compensation Committee, to oversee and ensure the proper implementation of the Stock Option Plan and to ensure the integrity of SafeNet's stock option granting policies and practices.

112. Defendants also misused their positions to improperly benefit by their access to inside information, in that they wrongfully caused the Company to issue to them options to purchase SafeNet stock at a materially understated price. The Officer Defendants' misrepresentations and/or omissions were intentional or reckless and done for the purpose of enriching themselves at the expense of Plaintiff and the Class.

113. The Defendants' scienter is also supported by their motive to sell substantial amounts of their SafeNet holdings at inflated prices. In particular, during the Class Period, the Officer and Director Defendants cumulatively sold 667,700 shares for combined proceeds of nearly \$20.5 million.

114. Throughout the Class Period, the prices of the Company's securities were artificially inflated as a direct result of Defendants' misrepresentations and omissions regarding the Company, including the misrepresentations about its financial condition and results and business condition and results.

115. The Company's financial condition and its stock option related practices, were material information to Plaintiff and the other members of the Class. In addition, the integrity of management is highly material to investors, and the issuance of stock options through either "backdating" or "spring loading" directly bears on investor confidence in the Company's management. Had the truth been disclosed to the market during the Class Period, Plaintiffs and the other Class members would have been unwilling to purchase the Company's securities at the prices at which they did purchase them, or at all.

116. When the truth about the Company was revealed as described above, the inflation that had been caused by Defendants' misrepresentations and omissions was eliminated from the price of the Company's securities, causing significant losses to Plaintiffs and the other Class members. This price decline occurred as the market fully digested the impact and meaning of Defendants' "backdating" or "spring loading" scheme and its impact on SafeNet. The declines in the Company's securities prices following the revelations of the accounting fraud and the Company's improper granting of stock options to senior executives and the resulting losses suffered by Plaintiffs and the other members of the Class are directly attributable to the market's

reaction to the disclosure of information that had previously been misrepresented or concealed by Defendants, and to the market's adjustment of the Company's securities prices to reflect the newly emerging truth about the Company's financial condition and business operations.

117. Defendants' conduct, as alleged herein, proximately caused foreseeable losses and economic harm to Plaintiff and the other members of the Class. The totality of the circumstances surrounding the drops of SafeNet's stock price following the disclosure on May 18, 2006 combine to negate any inference that the economic loss Plaintiff and other Class members suffered was caused by changed market conditions, macroeconomic or industry-wide factors, or SafeNet specific facts unrelated to Defendants' fraudulent conduct.

118. By virtue of the foregoing, Defendants have violated Section 10(b) of the Exchange Act and Rule 10b-5 promulgated thereunder.

### **COUNT III**

#### **FOR VIOLATIONS OF SECTION 20(a) OF THE EXCHANGE ACT ARISING FROM STOCK OPTION-RELATED MISREPRESENTATIONS AND BROUGHT AGAINST THE OFFICER DEFENDANTS AND THE DIRECTOR DEFENDANTS**

119. Plaintiff repeats and realleges each and every allegation above as if set forth fully herein.

120. The Officer Defendants and the Director Defendants were control persons of SafeNet by virtue of their positions as directors and/or as senior officers of SafeNet.

121. Each of the Officer and Director Defendants acted as a controlling person of the Company within the meaning of Section 20(a) of the Exchange Act during the Class Period. Specifically, defendant Caputo had the power and authority to cause the Company to engage in the wrongful conduct complained of herein, by virtue of his position as Chief Executive Officer and Chairman of the Board. Defendant Mueller also had the power and authority to cause the

Company to engage in the wrongful conduct complained of herein, by virtue of his position as Chief Financial Officer. Likewise, Defendant Argo had the power and authority to cause the Company to engage in the wrongful conduct complained of herein, by virtue of her position as President and Chief Operating Officer. The Director Defendants, including, in particular, the Compensation Committee Defendants, had overall responsibility and oversight over SafeNet's business operations in general, and executive compensation and stock option grants in particular. These Defendants were each in a position to control or influence the contents of, or otherwise cause corrective disclosures to have been made in the Company's SEC filings, along with the Company's other public statements that contained materially false and misleading statements that were disseminated during the Class Period.

122. By reason of the wrongful conduct alleged herein, the Individual Defendants are liable pursuant to Section 20(a) of the Exchange Act. As a direct and proximate result of their wrongful conduct, plaintiff and the other members of the Class suffered damages in connection with their purchases of SafeNet shares during the Class Period.

#### **COUNT IV**

#### **AGAINST SAFENET AND THE OFFICER DEFENDANTS FOR VIOLATIONS OF SECTION 10(b) AND RULE 10B-5 PROMULGATED THEREUNDER ARISING FROM SAFENET'S 2005 ACCOUNTING FRAUD AND MISREPRESENTED EARNINGS**

123. Plaintiff repeats and realleges each of the allegations set forth in the foregoing paragraphs.

#### **A. Background Regarding SafeNet's Accounting and Financial Reporting of Long-Term Development Contracts**

124. In addition to deceiving investors regarding its compensation costs and stock option granting practices, during the second and third quarters of 2005, SafeNet and the Officer

Defendants also knew or were reckless in not knowing that SafeNet's financial reporting violated GAAP and that its financial statements overstated SafeNet's reported income.

125. SafeNet derived a material portion of its revenues during the Class Period from certain long-term contracts through which SafeNet developed high assurance encryption technology and other security-related products and services for its customers, including government agencies or divisions. SafeNet applied "contract accounting" to report the financial effect of these long-term contracts. Various accounting rules, including SOP 81-1, *Accounting for Performance of Construction-Type and Certain Production-Type Contracts*, applied to SafeNet's accounting and disclosure relating to these contracts. As SafeNet disclosed in the "Management's Discussion and Analysis of Financial Condition and Results of Operations" ("MD&A") section of its Quarterly Report on Form 10-Q for the second quarter of 2005, which was filed with the SEC on August 9, 2005:

We recognize revenue and profit as work on long-term contracts progresses using the ***percentage of completion method of accounting, which relies on estimates of total expected contract revenues and costs***. We follow this method because reasonably dependable estimates of the revenue and costs applicable to various stages of a contract can be made. Because the financial reporting of these contracts depends on estimates, which are assessed continually during the term of the contract, recognized revenues and profit are subject to revisions as the contract progresses to completion. ***Revisions in profit estimates are reflected in the period in which the facts that give rise to the revision become known***. Accordingly, favorable changes in estimates result in additional profit recognition, and unfavorable changes in estimates result in the reversal of previously recognized revenue and profits. (Emphases added)

126. In other words, SafeNet (and the investors and market analysts who rely on the integrity of SafeNet's public disclosures) would "match" the anticipated benefits of each contract with the estimated costs to determine the gross margin and profitability of the deal. SafeNet estimated the future costs of delivering the products and services contemplated under the agreements. The estimates of future expenses constituted a liability against the expected income

from the contracts.

127. For contracts in which revenue recognition tied to contract milestones, for example, SafeNet informed investors that it would record the revenue only upon meeting those objectively documented milestones. For certain of SafeNet's other long-term development contracts, SafeNet told investors that it recorded revenues only when the costs related to achieving those revenues were actually incurred.

128. If the expenses SafeNet actually incurred in delivering products or services were below its initial estimates, SafeNet could "revise" its estimates by lowering the cost side of the equation. Any such "revisions" provided a dollar-for-dollar benefit to SafeNet's income and a concomitant improvement to gross margins.

129. During the second quarter of 2005, the Officer Defendants recognized that SafeNet's gross margins were rapidly deteriorating due to numerous factors. Rather than provide the investing public with a true picture of SafeNet's circumstances, the disclosure of which Defendants knew would cause SafeNet's stock price to plummet, Defendants deliberately manipulated SafeNet's accounting practices to overstate the Company's financial results and to obscure the slower growth and smaller gross margins facing SafeNet for the future.

**B. SafeNet's False and Misleading Statements Regarding Its Financial Results**

130. Defendants hid SafeNet's deteriorating margins and other financial problems by understating SafeNet's costs and overstating its revenues on long-term delivery contracts. Specifically, SafeNet "adjusted" downward the cost estimates established at the onset of certain long-term development contracts, thereby falsely portraying to investors that the contracts were more profitable than they actually were.

**The False and Misleading Second Quarter 2005 Disclosures**

131. On July 28, 2005, the Company issued (and filed with the SEC as an exhibit to a Current Report on Form 8-K signed by defendant Caputo) a press release (the “2Q 2005 Earnings Release”) announcing the Company’s financial results for the second quarter, ended June 30, 2005. The 2Q 2005 Earnings Release stated: “The net loss calculated on a GAAP (Generally Accepted Accounting Principles) basis for the quarter ended June 30, 2005, was a net loss of \$3.0 million or (\$0.12) per diluted share....” As set for below, Defendants manipulated the Company’s accounting to reduce its reported loss and falsify its reported gross margins.

132. Besides failing to properly recognize \$642,000 of restructuring costs relating to the exit of a leased facility, Defendants caused SafeNet to improperly manipulate its percentage of completion accounting for long-term delivery contracts in order to inflate reported revenues and income by \$356,000. The overstated contract revenue represented over 10% of SafeNet’s total reported loss for the quarter. The revenues and restructuring costs together ultimately resulted in a total restated loss of \$4.895 million or \$0.20 cents per share, approximately a 66% increased loss from the initially disclosed loss of \$0.12 per share.

133. On August 9, 2005, Defendants filed the Company’s second quarter 2005 Quarterly Report on Form 10-Q (the “2Q 2005 Form 10-Q”) with the SEC, which defendants Caputo and Mueller signed. The 2Q 2005 Form 10-Q disclosed a net loss for the quarter of \$3.811 million or (\$0.15) per diluted share and a net loss for the first six months of 2005 of \$2.573 million or (\$0.10) per diluted share. As detailed below, SafeNet’s reported results were materially false because of the failure to recognize restructuring costs and the overstatement of revenue from long-term contracts. SafeNet’s true net loss for the quarter was \$4.895 million or (\$0.20) per diluted share, a 33% increase from the net loss disclosed to investors on August 9, 2005.



134. Defendants also represented in Item 4 of the MD&A of the 2Q 2005 Form 10-Q the following:

As of the end of the period ended June 30, 2005, the Company carried out an evaluation, under the supervision and with the participation of the Company's management, including the Company's Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of the Company's disclosure controls and procedures pursuant to Rule 13a-15(e) under the Securities Exchange Act of 1934, as amended. ***Based upon that evaluation, the Chief Executive Officer and Chief Financial Officer concluded that the Company's disclosure controls and procedures are effective in timely alerting them to material information relating to the Company required to be included in the Company's periodic SEC filings. There were no changes in our internal controls over financial reporting during the second quarter of 2005 that materially affected or are reasonably likely to materially affect our internal controls over financial reporting.*** (Emphasis added).

135. The 2Q 2005 Form 10-Q also contained a materially false and misleading certification by defendants Caputo and Mueller, stating among other things that the 2Q 2005 Form 10-Q contained no material misstatements or omissions, that it fairly presented, in all material respects, the financial condition and results of operations of the Company and falsely stating that they had:

Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles.

136. As the Company later admitted in a Form 8-K/A filed with the SEC on March 13, 2006, and as further detailed below, the Company's internal controls over financial reporting in fact were not effective as of June 30, 2005, because the Company had material control deficiencies that allowed the fraud alleged herein.

### **The False and Misleading Third Quarter 2005 Disclosures**

137. On October 27, 2005, Defendants issued (and filed with the SEC as an exhibit to a Current Report on Form 8-K signed by defendant Caputo) a press release (the "3Q 2005

Earnings Release”) announcing the Company’s financial results for the third quarter, ended September 30, 2005. The 3Q 2005 Earnings Release stated: “The net income calculated on a GAAP (Generally Accepted Accounting Principles) basis for the quarter ended September 30, 2005, was \$1.1 million or \$0.04 per diluted share....” As set forth below, Defendants manipulated the Company’s accounting to reduce its reported loss and falsify its reported gross margins.

138. Defendants caused SafeNet to improperly manipulate its percentage of completion accounting for long-term delivery contracts in order to understate its reported costs, and thereby inflate its reported income, by \$731,000. As a result of Defendants’ understatement of long-term delivery contract costs, SafeNet reported net income of \$0.04 per share, which was four times the subsequently restated true net income of \$0.01 per share. SafeNet’s true net loss for the first nine months of 2005, as subsequently restated, was actually \$2.395 million, or a loss of 10 cents per share, a 66% higher loss than the initially reported loss of \$1.452 million, or \$0.06 per share.

139. On November 9, 2005, Defendants filed the Company’s third quarter 2005 Quarterly Report on Form 10-Q (the “3Q 2005 Form 10-Q”) with the SEC, which defendants Caputo and Mueller signed. The 3Q 2005 Form 10-Q disclosed net income for the quarter of \$717,000 or \$0.03 per diluted share and a net loss for the first nine months of 2005 of \$1.856 million or (\$0.08) per diluted share. As discussed below, SafeNet’s reported results were materially false and misleading and its net income for the quarter was first restated to \$178,000 or \$0.01 per diluted share and subsequently restated to \$235,000 (also \$0.01 per share), while the net loss for the first nine months was first restated to \$2.395 million or (\$0.10) per diluted share and subsequently restated to \$3.487 million or (\$0.14) per diluted share.

140. Defendants also falsely stated in Item 4 of the MD&A of the 3Q 2005 Form 10-Q the following:

As of the end of the period ended September 30, 2005, the Company carried out an evaluation, under the supervision and with the participation of the Company's management, including the Company's Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of the Company's disclosure controls and procedures pursuant to Rule 13a-15(e) under the Securities Exchange Act of 1934, as amended. *Based upon that evaluation, the Chief Executive Officer and Chief Financial Officer concluded that the Company's disclosure controls and procedures are effective in timely alerting them to material information relating to the Company required to be included in the Company's periodic SEC filings. There were no changes in our internal controls over financial reporting during the third quarter of 2005 that materially affected or are reasonably likely to materially affect our internal controls over financial reporting.* (Emphasis added).

141. The 3Q 2005 Form 10-Q also contained a materially false and misleading certification by defendants Caputo and Mueller, stating among other things that the 2Q 2005 Form 10-Q contained no material misstatements or omissions, that it fairly presented, in all material respects, the financial condition and results of operations of the Company and falsely stating that they had:

Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles.

142. As the Company later admitted in a Form 8-K/A filed with the SEC on March 13, 2006, and as further detailed below, the Company's internal control over financial reporting in fact was not effective as of September 30, 2005, because the Company had material control deficiencies that made the fraud alleged herein possible.

C. **Some, But Not All, of the Truth Concerning SafeNet's Fraudulent Accounting Practices Begins to Emerge**

**The February 2, 2006 Disclosure of SafeNet's Anticipated Restatements**

143. On February 2, 2006, Defendants issued (and later filed with the SEC as an exhibit to a Current Report on Form 8-K signed by defendant Caputo) a press release in which the Company reported its financial results for the fourth quarter of 2005 and disclosed for the first time that investors should not rely upon SafeNet's previously disclosed earnings for the second and third quarters of 2005 and that the financial statements for those quarters would be restated in the near future (the "February 2 Restatement Disclosure").

144. In the February 2 Restatement Disclosure, SafeNet reported fourth quarter earnings well below Wall Street expectations, with fourth quarter revenues of \$77.1 million and EPS at \$0.45, which were below analysts' consensus estimates of \$80 million and \$0.55, respectively. SafeNet reported GAAP income for the year at \$4.1 million or \$0.16 per diluted share. The February 2 Restatement Disclosure also stated as follows:

During the year end audit process, we discovered errors that impacted prior quarters but did not materially impact the full year results. One error occurred during the second quarter of 2005 which consisted of an understatement of lease restructuring charges of approximately \$700,000. Another error of approximately \$600,000 was related to an understatement of our costs of revenues in our Classified Government business in the third quarter of 2005. These errors will be corrected in a 10-Q/A filing shortly.

145. Following the release of SafeNet's admission that its prior financials were not reliable, SafeNet's stock price fell precipitously, dropping 15.2%, from \$32.72 per share on February 2, 2006 to \$27.75 on February 3, 2006, on volume of 5,860,500 shares, which was over 14 times the average volume for the period between October 1, 2005 and February 2, 2006.

146. As noted above, under GAAP, if actual costs came in below the earlier estimates SafeNet would only adjust its estimates downward and not restate its previously reported results. The restatement based on an "understatement of our costs of revenues" was effectively an admission that SafeNet had falsely understated its costs at the time the results were originally

reported.

147. Notwithstanding Defendants' false assertion that the "errors" they had discovered were not material, in fact the "errors" had a material impact on SafeNet's quarterly and annual earnings. These "errors" were also material to investors because they were not innocent mistakes, but rather were restatements of costs that were previously misstated in order to improve SafeNet's publicly reported earnings. These restatements therefore related directly to the integrity of SafeNet's management and the reliability of its financial reporting.

**The February 27, 2006 Misrepresentation About SafeNet's 2Q 2005 Results**

148. Defendants continued, however, to misrepresent the depth of SafeNet's financial reporting improprieties. On February 27, 2006, Defendants filed with the SEC a Form 8-K/A signed by defendant Caputo, in which SafeNet stated that after further reviewing its accounting, it would not restate its earnings for the second quarter of 2005. As noted below, SafeNet subsequently was forced to restate its second quarter 2005 earnings.

149. Also on February 27, 2006, SafeNet filed with the SEC an amended Form 10-Q for the third quarter of 2005, signed by Caputo and Mueller, admitting as to that quarter:

The Company restated its previously issued consolidated financial statements as of and for the three and nine-month periods ended September 30, 2005. ***The restated unaudited consolidated financial statements result primarily from an error made in the recognition of costs under certain long-term production contracts.*** During the three-month period ended September 30, 2005 the Company failed to properly recognize \$731 of costs of product sales related to two long-term production contracts that were completed during the period, which resulted in an ***understatement of costs of goods sold and an overstatement of inventory at the balance sheet date.*** (Emphases added). [Dollar Amounts in Thousands]

150. The effect of this restatement of SafeNet's reported income was material, decreasing reported income for the quarter from \$717,000 (or 3 cents per share) to \$178,000 (or 1 cent per share), representing approximately a 75% decrease in total reported income for the

quarter and increasing the reported net loss for the first nine months of 2005 from \$1,856,000 (a loss of 8 cents per share) to \$2,395,000 (a loss of 10 cents per share), representing a 25% increase in the reported loss.

**SafeNet Admits Material Weaknesses In Its Internal Controls and that the Company Had To Restate Its Second Quarter 2005 Results**

151. In a press release dated March 13, 2006 (which was attached to SafeNet's Form 8-K/A of the same date), SafeNet disclosed that notwithstanding its February 27, 2006 announcement that the Company would not restate its financial results for the second quarter of 2005, in fact such a restatement was required (the "March 13 Form 8-K/A"). The March 13 Form 8-K/A stated:

[A]fter further review and discussions with Ernst & Young LLP, the Company's independent registered public accounting firm, in connection with the audit of the Company's financial statements for the year ended December 31, 2005, the Company and its Audit Committee, as well as Ernst & Young LLP, have reexamined this matter and the second quarter Form 10-Q and concluded that *the adjustments resulting from such previously disclosed errors are material in relation to previously reported results of operations. Accordingly, the financial statements included in the June 30, 2005 Form 10-Q should no longer be relied upon.* As disclosed previously, these errors are principally attributable to the accounting for a restructuring accrual related to the exit of an operating lease approximating \$650,000, as well as other individually less material errors approximating \$400,000 in the aggregate. The Company expects these adjustments to result in a net loss per common share, on GAAP basis of \$0.20 and \$0.15 for the three and six months ended June 30, 2005, respectively, rather than a net loss per common share of \$0.15 and \$0.10, respectively, as reported for such periods in the June 30, 2005 Form 10-Q.

The adjustments to second quarter will also result in cumulative adjustments to certain information presented in the September 30, 2005 Form 10-Q for the nine months ended September 30, 2005. As a result of these adjustments, the Company expects that (sic) net loss per common share, on a GAAP basis, to be \$0.14 for the nine months ended September 30, 2005, rather than \$0.10 as reported for such period in the September 30, 2005 Form 10-Q/A (Amendment No. 1).

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*For the full year 2005, net income per diluted share decreased from \$0.16, as previously announced in the press release on February 2, 2006, to \$0.12 as a result*

*of the adjustments discussed in this Amendment No. 2 to Form 8-K/A.* (Emphases added).

152. As a result of SafeNet's restatement of its second quarter 2005 results (the "2Q 2005 Restatement"), SafeNet's net loss per share for the quarter increased from 15 cents to 20 cents per share, representing a 33% adjustment in the Company's net loss per share for that quarter. The net loss per share for the first six months of 2005 increased from 10 to 15 cents, representing a 50% adverse adjustment in the Company's net loss for that period, and the net loss for the first nine months of 2005 increased from 10 to 14 cents per share, representing a 40% adverse adjustment in the Company's net loss for that time period. Net income for the year decreased by 25%, from 16 cents to 12 cents per diluted share.

153. In connection with the March 13 Form 8-K/A, SafeNet also admitted that contrary to Defendants' prior statements and certifications, material weaknesses in internal controls existed and that they inadequate controls allowed for SafeNet's false financial reporting:

***[M]anagement has currently identified a material weakness in internal control as of December 31, 2005. A material weakness is a control deficiency, or combination of control deficiencies, that results in more than a remote likelihood that a material misstatement of the annual or interim financial statements will not be prevented or detected. The material weakness pertains to insufficient staffing and technical expertise in the Company's accounting and financial reporting functions. The inadequate level of staffing and technical expertise results in certain accounting processes and controls around the financial statement close and financial reporting processes not being performed correctly, or on a timely basis. As a result of this weakness, material adjustments were identified related to accounting for revenue and costs on long-term contracts, plus other less material adjustments. The lack of sufficient staffing and technical expertise has reduced the effectiveness of the existing accounting and financial reporting function in its monitoring and evaluation of the financial position and operating results of the Company, thereby increasing the risk of a financial statement misstatement.***

The adjustments resulted in the restatement of the Company's financial statements for the three and six month periods ended June 30, 2005 and the three and nine month periods ended September 30, 2005. ***Accordingly, management has determined that this deficiency in controls reflects a material weakness. Because of this material weakness, management has concluded that the Company did not***

*maintain effective internal control over financial reporting as of December 31, 2005* based on the criteria in COSO Internal Control — Integrated Framework. In addition, as a result of these findings, management believes that the Company's disclosure controls and procedures as of the end of second and third quarters and year ended 2005 were ineffective. (Emphases added).

154. On March 13, 2006, Defendants issued a press release that quoted defendant Caputo as follows: “While we are still in the process of evaluating our internal controls, we have concluded that a material weakness existed as of December 31, 2005 and, therefore, we have already increased accounting personnel and are putting in place a plan to greatly strengthen our internal review function.”

#### **SafeNet's Second Quarter Restatement Is Filed on May 1, 2006**

155. On May 1, 2006, SafeNet filed its Amended Form 10-Q for the second quarter of 2005, which defendants Caputo and Argo signed (the “Restated 2Q 2005 Form 10-Q”). The Restated 2Q 2005 Form 10-Q disclosed that:

During the three-month period ended June 30, 2005 the Company failed to properly recognize \$642,000 of restructuring costs related to an exited leased facility, which resulted in an understatement of restructuring expense. The Company also made an error in the percentage of completion calculation related to a long-term production contract that resulted in an overstatement of revenue for the three and six month periods ended June 30, 2006 of \$356,000.

156. The restatement materially affected SafeNet's reported earnings, with the loss for the second quarter increasing from \$3,811,000 (or 15 cents per diluted share) to \$4,895,000 (or 20 cents per share). The loss for the first half of 2005 increased from \$2,573,000 (or 10 cents per share) to \$3,722,000 (or 15 cents per share).

157. Also on May 1, 2006, SafeNet filed its Amended Form 10-Q for the third quarter of 2005, which defendants Caputo and Argo signed (the “Second Restated 3Q 2005 Form 10-Q”). The Second Restated 3Q 2005 Form 10-Q disclosed the effect of the second quarter restatement on the financial results reported for the first nine months of 2005.



**SafeNet Changed Its Revenue Recognition Policies To Make It Easier to Manipulate Earnings on Long-Term Development Contracts**

158. SafeNet filed its Annual Report for 2005 on Form 10-K on March 16, 2006 (the “2005 Form 10-K”). The 2005 Form 10-K belatedly disclosed that during 2005, SafeNet had abandoned its prior practice of recognizing revenue only upon hitting objectively established and negotiated contractual milestones in favor of recognizing revenue on the basis of costs incurred in relation to delivery of product. Specifically, in each of its 10-Qs during the Class Period, SafeNet had disclosed the following:

Revenues that are earned under long-term contracts to develop high assurance encryption technology are recognized using contract accounting. Under contract accounting, revenue from these arrangements is recognized using the percentage-of-completion method. ***Progress to completion is principally measured using contract milestones. Management considers contract milestones to be the best available measure of progress on these contracts since each milestone contains customer-specified acceptance criteria.*** (Emphasis added).

159. The 2005 Form 10-K disclosed that SafeNet started booking revenue on the basis of different criteria, allowing it to record revenue even before hitting contractual milestones:

Revenues that are earned under certain long-term contracts to develop high assurance encryption technology are recognized using contract accounting and included in product revenue. Under contract accounting, revenue from these arrangements is recognized using the percentage-of-completion method. ***Progress to completion is measured using either labor hours or contract milestones based on the Company’s determination of which would be the best available measure of progress on the contracts.***

160. In other words, by changing its recognition policies mid-year, SafeNet could take advantage of this undisclosed change in accounting policy to book revenue based on work hours instead of objective progress to completion of the contract. As a result of SafeNet’s actions, the amount of its revenue that was recorded but not yet billed to clients materially increased during 2005. Thus, in order to support its near-term earnings (and prevent the market from understanding the depth of SafeNet’s gross margin and earnings shortfalls), SafeNet changed its

accounting policy to accelerate its revenue recognition at the expense of subsequent earnings.

**The April 6, 2006 Disclosure of CFO Mueller's Termination**

161. The investing public learned more bad news about the depth of SafeNet's financial control and reporting problems on April 6, 2006, when SafeNet issued a press release (also filed with the SEC as an exhibit to a Form 8-K the same day and signed by Caputo). The April 6 press release disclosed that SafeNet would miss its prior earnings forecasts for the first quarter of 2006 and that it had removed defendant Mueller from his position as CFO. Defendant Argo stepped in as interim CFO.

162. The market reacted swiftly to SafeNet's disclosure of missed and lower expected earnings and the firing of CFO Mueller. SafeNet's stock price fell 19.3%, from \$25.97 on April 6, 2006 down to \$20.96 on April 7, 2006, on volume of 6,199,400 shares traded, over 12 times the average trading volume during the period from December 9, 2005 through April 6, 2006.

163. SafeNet investors suffered yet another decline on May 18, 2006, when SafeNet disclosed in a press release that the SEC had made an informal inquiry, seeking information regarding SafeNet's "stock option grants to directors and officers of the Company, *as well as information relating to certain accounting policies and practices.*" Following the disclosure of the SEC's inquiry into, among other things, its accounting practices, the price of SafeNet stock dropped another 21%, from \$19.21 on May 18, 2006, to \$14.93 on May 19, 2006.

**D. Additional Allegations Pertinent to Defendants' Scienter**

164. Defendants acted with scienter in that Defendants knew and/or recklessly disregarded that the public documents and statements issued or disseminated in the name of the Company were materially false, incomplete and misleading; they knew those statements would be disseminated to the public; and they knowingly and substantially participated or acquiesced in

the issuance or dissemination of such statements or documents as primary violations of the federal securities laws.

165. Also, on top of the highly unusual and suspicious option grants discussed above, Defendants engaged in various securities transactions during the Class Period that are suspicious in terms of timing and scope, and therefore are probative of their scienter to commit securities fraud.

166. Several months before the Company disclosed its numerous restatements and diminished earnings expectations, on December 7, 2005, defendant Caputo established a 10b5-1 trading plan indicating he would sell up to 100,000 SafeNet shares over the next few months. SafeNet's Form 4s indicate that he followed through with the plan, selling all of the shares by no later than February 17, 2006, and the bulk of the shares prior to the February 2, 2006 disclosures of the restatements and reduced forward earnings guidance. In total, Caputo sold 100,000 shares of SafeNet stock at prices between \$25.75 and \$33.80 for total proceeds of \$3.153 million.

167. Also, on or about November 23, 2005, a short time before the disclosure of SafeNet's fraudulent accounting practices, defendant Mueller sold 12,500 shares of SafeNet stock at \$36.61 for total proceeds of \$457,625.

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168. Throughout the Class Period, Defendants individually and in concert, directly and indirectly, by the use and means of instrumentalities of interstate commerce and/or of the mails, engaged and participated in a continuous course of conduct to conceal material adverse information about SafeNet, including its reported financial results, financial controls and true financial condition and its improper practices with respect to the granting off stock options to the Company's senior executives, as specified herein. Defendants employed devices, schemes, and

artifices to defraud while in possession of material, adverse non-public information and engaged in acts, practices, and a course of conduct that included the making of, or participation in the making of, untrue and/or misleading statements of material facts and/or omitting to state material facts necessary in order to make the statements made about SafeNet not misleading.

Specifically, Defendants knew or should have known that their statements concerning the Company's financial results, internal controls and stock option practices throughout the Class Period as filed with the SEC and disseminated to the investing public were materially false, incomplete and misleading.

169. The Officer Defendants, as the directors and/or top executive officers of the Company, are liable as direct participants in the wrongs complained of herein. Through their positions of control and authority as officers and/or directors of the Company, the Officer Defendants were able to and did control the content of the public statements disseminated by SafeNet. With knowledge of or recklessness as to the falsity and/or misleading nature of the statements contained therein and in reckless disregard of the true operations and finances of the Company, the Officer Defendants caused the heretofore complained of public statements to contain misstatements and omissions of material facts as alleged herein.

170. The Officer Defendants acted with scienter throughout the Class Period, in that they either had actual knowledge of the misrepresentations and/or omissions of material facts set forth herein, or acted with reckless disregard for the truth in that they failed to ascertain and to disclose the true facts, even though such facts were available to them. The Officer Defendants constituted the senior management of the Company, and were therefore directly responsible for the false and misleading statements and/or omissions disseminated to the public through press releases, news reports, and filings with the SEC.

171. The Officer Defendants' scienter is also supported by their motive to sell substantial amounts of their SafeNet holdings at inflated prices. In particular, during the period from July 28, 2005 through May 18, 2006, the Officer Defendants cumulatively sold 114,500 shares for combined proceeds of nearly \$3.7 million. The Officer Defendants also misused their positions to improperly benefit by their access to inside information, in that they wrongfully caused the Company to issue to them 225,000 options to purchase SafeNet stock at a materially understated price. The Officer Defendants' misrepresentations and/or omissions were intentional or reckless and done for the purpose of enriching themselves at the expense of Plaintiff and the Class.

172. The prices of SafeNet's securities were artificially inflated as a direct result of Defendants' misrepresentations and omissions regarding the Company, including the misrepresentations about its financial condition and results and business condition and results.

173. The Company's financial condition, including revenues and expenses related to its long-term development contracts, its internal controls and its stock option related practices, were material information to Plaintiff and the other members of the Class. In addition, the integrity of management is highly material to investors, and the issuance of stock options through either "backdating" or "spring loading" directly bears on investor confidence in the Company's management. Had the truth been disclosed to the market during the Class Period, Plaintiff and the other Class members would have been unwilling to purchase the Company's securities at the prices at which they did purchase them, or at all.

174. When the truth about the Company was revealed as described above, the inflation that had been caused by Defendants' misrepresentations and omissions was eliminated from the price of the Company's securities, causing significant losses to Plaintiff and the other Class

members. The declines in the Company's securities prices following the revelations of the accounting fraud and the Company's improper granting of stock options to senior executives and the resulting losses suffered by Plaintiff and the other members of the Class are directly attributable to the market's reaction to the disclosure of information that had previously been misrepresented or concealed by Defendants, and to the market's adjustment of the Company's securities prices to reflect the newly emerging truth about the Company's financial condition and business operations.

175. Defendants' conduct, as alleged herein, proximately caused foreseeable losses and economic harm to Plaintiffs and the other members of the Class. The totality of the circumstances surrounding the drops of SafeNet's stock price following the disclosures on February 2, 2006, April 7, 2006 and May 18, 2006 combine to negate any inference that the economic loss Plaintiff and other Class members suffered was caused by changed market conditions, macroeconomic or industry-wide factors, or SafeNet specific facts unrelated to Defendants' fraudulent conduct.

176. By virtue of the foregoing, Defendants have violated Section 10(b) of the Exchange Act and Rule 10b-5 promulgated thereunder.

#### **COUNT IV**

#### **AGAINST THE OFFICER DEFENDANTS FOR VIOLATIONS OF SECTION 20(a) OF THE EXCHANGE ACT ARISING FROM SAFENET'S 2005 ACCOUNTING FRAUD AND MISREPRESENTED EARNINGS**

177. Plaintiff repeats and realleges each and every allegation set forth in the paragraphs above, as if set forth fully herein.

178. The Officer Defendants were control persons of SafeNet by virtue of their positions as directors and/or as senior officers of SafeNet.

179. Each of the Officer Defendants acted as a controlling person of the Company within the meaning of Section 20 of the Exchange Act during the Class Period. Specifically, defendant Caputo had the power and authority to cause the Company to engage in the wrongful conduct complained of herein, by virtue of his position as Chief Executive Officer and Chairman of the Board. Defendant Mueller also had the power and authority to cause the Company to engage in the wrongful conduct complained of herein, by virtue of his position as Chief Financial Officer. Likewise, defendant Argo had the power and authority to cause the Company to engage in the wrongful conduct complained of herein, by virtue of her position as President and Chief Operating Officer. These Defendants were each in a position to control or influence the contents of, or otherwise cause corrective disclosures to have been made in the Company's SEC filings, along with the Company's other public statements that contained materially false and misleading statements that were disseminated during the Class Period.

180. By reason of the wrongful conduct alleged herein, the Officer Defendants are liable pursuant to Section 20(a) of the Exchange Act. As a direct and proximate result of their wrongful conduct, plaintiff and the other members of the Class suffered damages in connection with their purchases of SafeNet shares during the Class Period.

#### **PRAYER FOR RELIEF**

WHEREFORE, plaintiff prays for relief and judgment, as follows:

1. Declaring this action to be a proper class action pursuant to Rule 23(a) and Rule 23(b)(3) of the Federal Rules of Civil Procedure on behalf of the Class defined herein;
2. Awarding Plaintiff and the members of the Class compensatory damages;
3. Awarding Plaintiff and the members of the Class pre-judgment and post-judgment interest, as well as reasonable attorneys' fees, expert witness fees and other costs;

4. Awarding preliminary and permanent injunctive relief in favor of Plaintiff and the Class against Defendants and all persons acting in concert with them, including a constructive trust over the Individual Defendants' unjust enrichment;

5. Ordering disgorgement of all stock option proceeds and/or profits obtained through the exercise of stock options granted to the Individual Defendants by virtue of the false and misleading Proxy Statements;

6. Ordering that all unexercised stock options held by the Individual Defendants be rescinded; and

7. Awarding such other relief as this Court may deem just and proper.

**JURY DEMAND**

Plaintiff demands a trial by jury.

DATED: New York, New York  
August 1, 2006

**BERNSTEIN LITOWITZ BERGER  
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