STOCK SALES

INSIDERS WITH A CURIOUS EDGE

How corporate executives seem to be violating the spirit, if not the letter, of a rule meant to prevent insider trading

BY JANE SASSEEN

THE CONFUSION OVER corporate executives trading on inside information never seems to go away. In 2000 the Securities & Exchange Commission came up with a way to remove the guesswork over when it's legal to trade and when it's not. But a raft of recent trades by executives suggests the plan might not be the cure-all that was hoped for.

The SEC's solution was to create prearranged trading plans, known as 10b5-1 plans for the rule that authorized them. Launched six years ago, they were designed to remove discretion from executives' trades and provide a "safe harbor" from insider trading charges. The rules: Executives can't set up a plan when they possess material inside knowledge, and they must set the dates or prices of their trades in advance.

But those are the only major stipulations. The SEC never addressed the number of shares sold or the possibility of stopping and starting plans or running multiple plans at once. As a result, executives have far more flexibility than is generally understood. Besides providing legal cover, the plans allow execs to trade around earnings announcements and other significant events. Normally insiders are prohibited from trading on these "blackout dates."

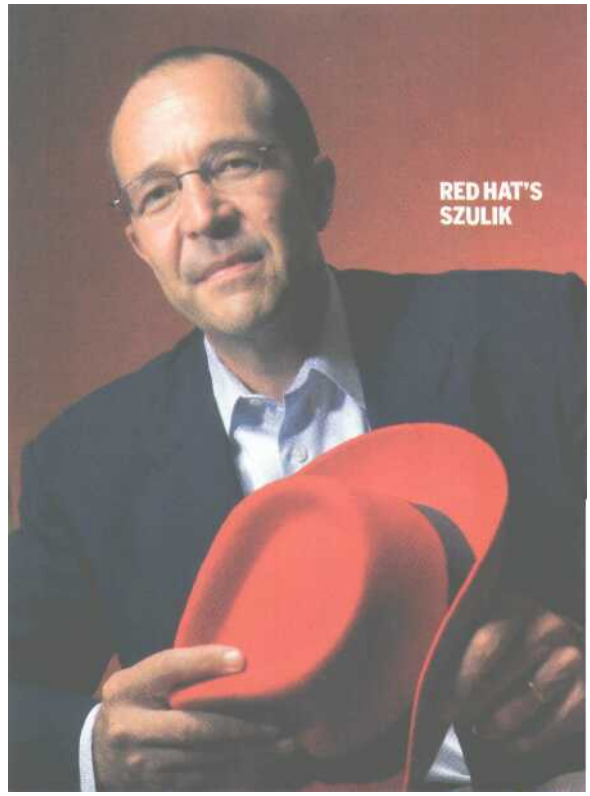
Executives appear to be using their flexibility to the max. People selling shares in 10b5-1 plans generate returns substantially better than would be expected if the trading were truly automatic. As reported in *BusinessWeek* on Nov. 6, Alan D. Jagolinzer, an assistant professor at Stanford University Graduate School of Business, recently completed a study of roughly 117,000 trades in 10b5-1 plans by 3,426 executives at 1,241 companies. He found that trades inside the plans beat the market by 6% over six months.

Those numbers imply that the rules allow execs to benefit from inside knowledge. "The SEC's intent was to shelter people who didn't have any [material] inside knowledge from liability," says Jesse M. Fried, a Stanford law professor and expert on executive compensation who has reviewed Jagolinzer's study. "But that outperformance suggests instead that it's the people using what information they have who are most often entering into trading plans." Says Walter G. Riccardi, deputy director of the SEC's Enforcement Div.: "Setting up a 10b5-1 plan while in possession of material information... could be securities fraud."

BusinessWeek examined a database created by Thomson Financial of companies that had suffered a 20% stock slide in the past year and, from that group, focused on the roughly 150 where executives had used 10b5-1 plans and where significant trading—both inside and outside plans—had taken place.

> Execs can stop, restart, or amend trading plans that are meant to be prearranged and automatic

The results? *BusinessWeek* found a surprising amount of leeway over preplanned trades. At nearly half the companies examined, sales were concentrated in the months leading up to a stock's peak or just thereafter. Frequently, the number of shares sold


RED HAT'S SZULIK

increased as the stock hit new highs, then trailed off or ended as the stock dove.

There are many possible explanations. One, says Michael Painchaud, president of Market Profile Theorems Inc., a Seattle executive trading tracker, is that top officials often know about a company's prospects long before the information is considered legally "material." Another explanation: Many executives pay close attention to valuation levels and decide to cash out after they've seen a big rise. "Insiders know that institutional traders can be very fickle and that money will go elsewhere if their momentum starts to slow," says Mark LoPresti, who follows executive trades for Thomson Financial. In fact, sales in some plans are automatically triggered when stocks reach certain price targets.

Still, the words "prearranged trading plans" bring to mind a steady pattern of trading over a long period of time. When discussing their plans, companies tend to reinforce that perception, says LoPresti. But in reality, many executives sell huge numbers of shares in a very short time, and often right before a tumble.

SWEET RIDE

CONSIDER RECENT TRADES made by Paul J. Sarvadi, chairman and CEO of Administaff Inc. Shares of the Kingwood (Tex.) provider of personnel management services soared from about 15 in May, 2005, to around 42 at the end of October. During that span, Sarvadi used a trading plan to sell shares worth an average of around $2.3 million a month. When the stock plateaued in November, his sales stopped. By spring, after the stock began another ascent, Sarvadi was ready to sell again. He instituted a new trading plan on Mar. 9, and from Apr. 3 to May 1 sold shares for $19 million.

His timing was impeccable. The last trade was at 59. On May 2, Administaff posted strong first-quarter earnings, but second-quarter forecasts disappointed investors. By May 3 the stock had plunged 25%, to 44, then slid to around 31 by late July. Administaff declined to comment.

Matthew J. Szulik, chairman and CEO of software maker Red Hat Inc. appears to have had similarly good timing. After the stock nearly tripled in 2005, he began selling shares through a plan on Jan. 5, 2006, with sales of 1 million shares for $24 million. From late January to June, he sold roughly 1 million more shares for $28 million. The stock hit 32 in May. But weaker-than-expected results in the June and September quarters sent the stock tumbling, to around 16. Red Hat declined to comment.

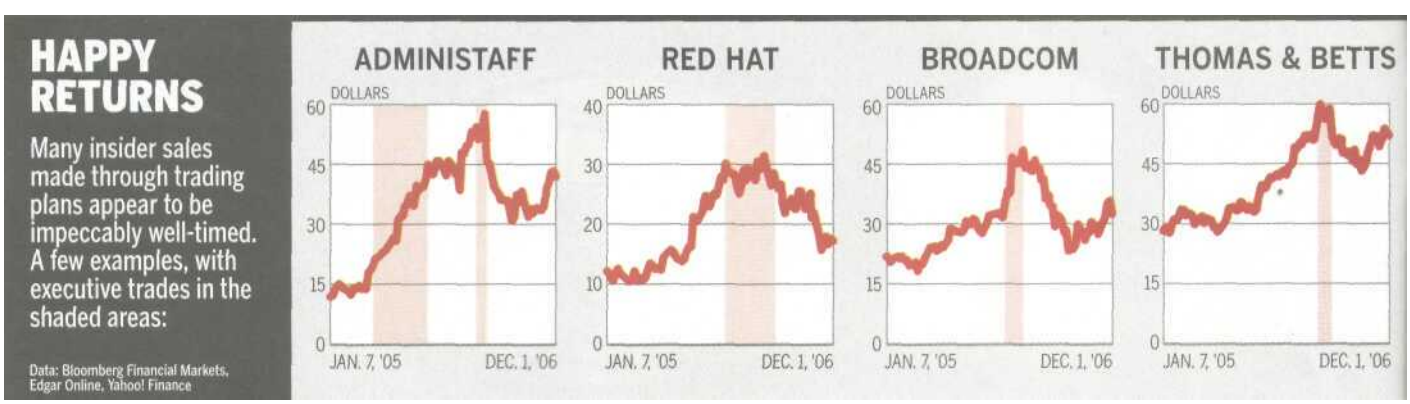
Analysts say such results aren't so surprising when trades are made right after plans are put into effect. But in many cases plans put in place long before trades begin also seem presciently timed.

Take the slew of trades made by executives at health insurer Aetna Inc. earlier this year. From early October to mid-November, 2005, three execs set up plans through which they sold shares during the month of February, 2006. As the stock peaked above 50—up from 10 three years earlier—Chief Financial Officer Alan M. Bennett sold 233,333 shares worth $14.2 million, Senior Vice-President Craig R. Callen cashed out for $3 million, and John W. Rowe, who retired as CEO that month but remained executive chairman through September, sold shares for $44 million.

The stock peaked on Feb. 23. Some analysts began raising questions about whether Aetna had priced its policies too aggressively the previous fall. Those fears appeared to be confirmed in April when results for the March quarter showed that Aetna was spending a higher portion of its premiums providing care than it had a year earlier. The stock lost 20% in one trading day. In July, when second-quarter numbers showed things getting worse, shares fell 17% in a day. An Aetna spokesman says selling was part of their "systematic planning" for retirement and other things.

The Aetna example points to another issue: groupthink. Companies stress that trading plans represent the personal financial decisions of executives to diversify holdings and have nothing to do with anyone's opinions on the stock's prospects. Yet in many cases more than one executive seems to arrive at that personal decision at the same moment.

In late April, for example, after a 10-month run in which shares of Memphis-based electrical manufacturer Thomas & Betts Corp. doubled, to almost 60, two top officials began selling shares. Over the next six weeks, CEO Dominic



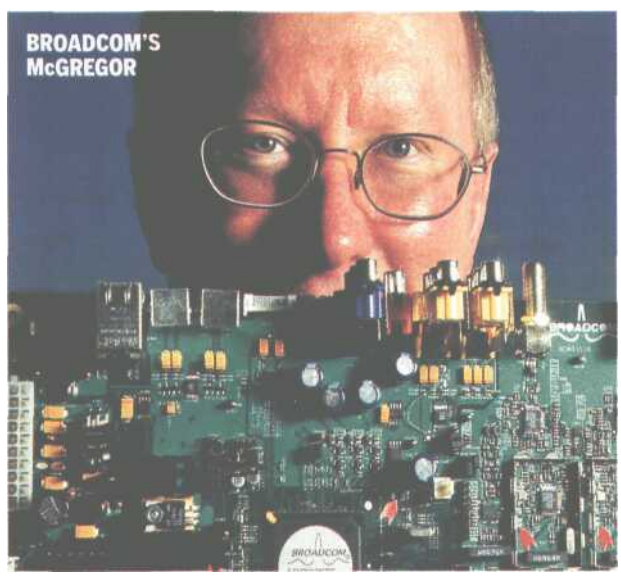
Setting up a trading plan "while in possession of material information...could be securities fraud," says the SEC

J. Pileggi sold $7 million worth of stock, while CFO Kenneth W. Fluke sold $6 million worth over five weeks. In June, as the company's growth slowed, the stock fell below 50; a month later it was down to 45. Thomas & Betts declined to comment other than to say the plans were set up in mid-March.

Another curious pattern: a sharp rise in selling. Broadcom Corp. CEO Scott A. McGregor sold shares from May, 2005, through March of this year. But while his automatic sales in 2005 averaged 2,750 shares a month for around $110,000, in January his trading went into overdrive. From Jan. 3 to Mar. 2 he sold some 350,000 shares for almost $19 million. Many of those sales came as the stock surged toward 46 on Jan. 27 on better-than-expected performance. After analysts slashed their earnings estimates in April, the stock began a three-month slide, to around 22. While the stock was also hurt by probes into Broadcom's stock options practices, in July it also said third-quarter growth would fall well below forecasts. Broadcom did not respond to repeated requests for comment. Similarly, Netflix Inc. CFO Barry W. McCarthy Jr. sold 4,000 shares a week from November, 2005, to July, 2006. But on Apr. 19—less than a week before the stock peaked at 31—McCarthy sold an additional 40,000 shares for $1.2 million. Netflix declined to comment.

Analysts say executives' outperformance in 10b5-l plans may be magnified by the fact that they can sell just before or after earnings are announced, or on other blackout dates when significant news affects stock prices. "That gives them an advantage over their co-workers," says Thomson Financial's LoPresti. "Not only can they trade on more days, [but] those days surround pivotal events." John C. Burris, senior vice-president at network software maker Citrix Systems Inc., sold 310,000 shares on Apr. 21 for $12.6 million, two days after strong first-quarter numbers sent the stock soaring 5%. Citrix did not respond to requests for comment.

Despite the "prearranged" nature of the trading plans, executives have enormous flexibility to start, stop, restart, and amend them at will. Some use the plans to trade just once; others use overlapping plans. At software maker Openwave Systems Inc., Chief Administrative Officer Steve Peters set up a plan on Jan. 31 to sell roughly 17,000 shares in early March for $308,000. On Feb. 8 he set up another plan to sell 73,506 shares on Mar. 13, which he unloaded for $1.48 million. By April the stock had started a sharp drop from around 22 to 6 as investors bailed out in the face of weakening profits and an SEC probe into whether Openwave had backdated options. "If [executives are] ending plans and starting new ones with each trade," says Berkeley's Fried, "how does that differ from simply trading outside of a plan?" Peters no longer serves as CAO; he does, however, remain a part-time adviser. Openwave doesn't comment on individual employee trading plans.



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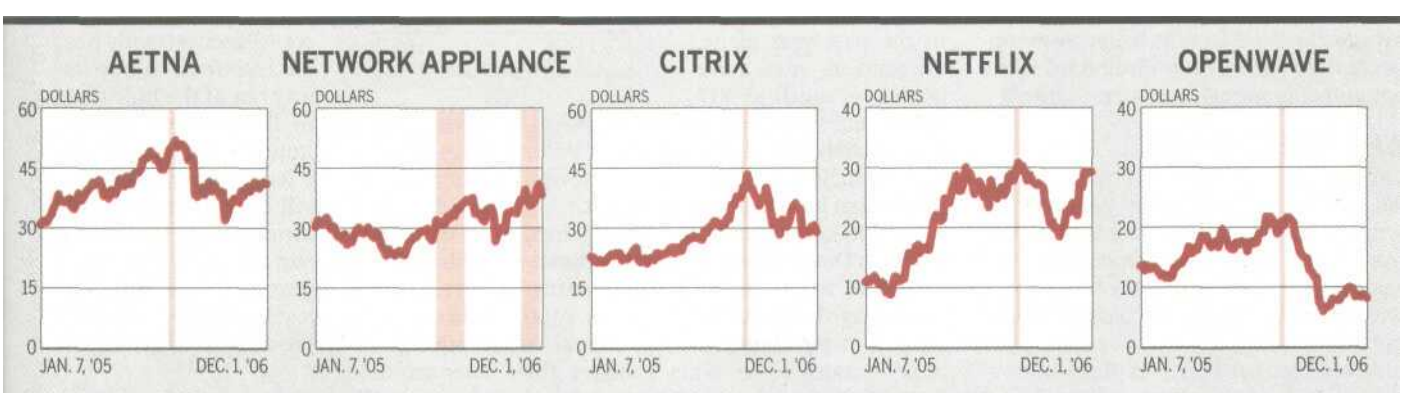
Starting and stopping plans at will can enable execs to hit multiple stock peaks. After shares at storage technology outfit Network Appliance Inc. rose 28%, to around 30, late last year, CEO Daniel Warmenhoven set up a plan under which he sold 600,000 shares for roughly $20 million from January to March. The sales stopped just before weaker earnings sent the stock tumbling below 28. In late August, after performance started to mend, Warmenhoven set up a new plan. Starting in mid-September he sold shares worth $15 million as the stock rose into the high 30s. His most recent automatic trade? Forty thousand shares, worth $1.6 million, on Nov. 16, a day after a strong earnings report sent the shares up 5%. Network Appliance didn't respond to requests for comment. II

-With Megan Tucker, Nichola Saminather, Lorraine Woellert, John Cody, Susan Zegel, and bureau reports



Fonte: Business Week, n. 4014, p. 38-41, 18 Dec. 2006.