CUG.COMments

A Newsletter from Chicago Underwriting Group, Inc.
Underwriters of D & O and Professional Liability Insurance

Issue 50 **May 2007**

10b5 TRADING PLANS REVISITED

The October 2000 issue of CUG.COMments discussed the SEC's recently promulgated Rule 10b5-1 that included a provision for executives to create trading plans for selling their company stock in accordance with pre-arranged parameters.[1] Nearly seven years later we revisit the subject.

10b5 Plans and D&O Underwriting

Trading plans are intended to take spontaneous trading decisions out of the hands of executives, thereby providing a possible defense against litigation. Accordingly, D&O insurers have usually looked favorably upon the existence of such plans: the general belief seems to have been that they certainly can't hurt.

Academic Scrutiny

This belief has been called into question as a result of recent research conducted by assistant professor Alan D. Jagolinzer of Stanford University Graduate School.[2] After studying numerous trades made by insiders within trading plans and trades made by insiders who traded without a trading plan, he concluded that executives with plans out-performed the market by 5.6% over a six month period.

A Reassessment of 10b5 Plans?

Professor Jagolinzer is careful not to jump to rash conclusions from his work: "It is important to note that it is not clear whether the evidence described in this study is indicative of any illegal behavior by participants."[3] However any belief that the mere existence of a trading plan indicates a kind of higher morality should probably be reassessed.

The research reminds us that even though trades within a plan are typically beyond an executive's control, trading plans can be set up, cancelled or amended at the discretion of the executive. A trading plan is not like a blind trust: executives know what is in them, they know the plan limitations and they know the plan's timetable for selling.

Qwest: The Double-edged Sword in Action

A reasonable conclusion might be that properly drafted and executed plans can still offer advantages, but inappropriate manipulation prompted by restricted knowledge could invite trouble. The recent trial of Joseph P. Nacchio, former CEO of Qwest, is an example of both benefits and drawbacks.

In December 2005, Mr. Nacchio was indicted on 42 counts of securities fraud and insider trading.[4] Each charge related to Qwest stock trades made by Mr. Nacchio from January 2, 2001 through May 29, 2001, trades allegedly based on non-public material information. These 42 trades involved a total of 2,528,723 shares sold for accumulated proceeds of $100,812,582. Mr. Nacchio's trial began in Denver on March 19, 2007.

The Verdict

After a month-long trial the verdicts were read on April 19. On counts one through twenty-three the jury's decision was consistent: not guilty. But the verdicts on the nineteen remaining counts were equally unswerving: guilty. What could have caused the split?

Starting on February 20, 2001 Mr. Nacchio's hitherto apparently random stock sales assumed a fixed

pattern. He sold 11,500 shares on that day and then routinely sold 11,500 shares on each of the next seven business days: Mr. Nacchio had set up a stock trading plan.

The last trade under the plan took place on March 1, after which the plan was cancelled. That March 1 trade became count number twenty-three and was the last count on which he was found not guilty. After cancelling the plan it was not until April 26 that the next sale took place: 350,000 shares were sold, constituting the largest single day's sale in the period covered by the indictments. That trade became count twenty-four, the first on which Mr. Nacchio was found guilty.

Summary

The decision to cease the orderly, modest sale of stock under the trading program was probably not the most crushing evidence against the defendant. That probably occurred on April 24, two days before his huge stock sale, when Mr. Nacchio publicly announced that Qwest's aggressive growth goals remained viable. These comments contradicted internal company information. Nevertheless, starting a trading plan then abruptly and unaccountably ending it did not help his case.

The trial and conviction of Joseph Nacchio illustrate some of the benefits and potential hazards of 10b5 trading plans. As Linda Chatman Thomsen, Director of the SEC's Enforcement Division, put it bluntly in a March 8, 2007 speech: "[Professor Jagolinzer's research] raises the possibility that plans are being abused in various ways to facilitate trading based on inside information. We're looking at this — hard."[5]

D&O Underwriting Implications

For 10b5 trading plans to create meaningful benefit in our D&O underwriting evaluation, the plans should generally follow these criteria: 1) the plan should be created during a time when there is minimal insider information that could be material; 2) the plan's existence should be publicly disclosed by filing an 8-K form with the SEC; 3) such disclosure should be thirty days, and preferably longer, before the first trade under the plan; 4) modifications to the plan should be limited; 5) the plan should only be suspended or cancelled infrequently and with caution, and 6) a series of smaller trades within the plan are typically better than a few large trades. ❖

Sources

1. http://www.cug.com/img/pdf/ISSUE12.pdf
2. http://papers.ssrn.com/sol3/papers.cfm?abstract_id=541502
3. Page 27 of Professor Jagolinzer's paper.
4. http://www.cug.com/img/pdf/Issue50-NaInd.pdf
5. http://www.sec.gov/news/speech/2007/spch030807lct2.htm

CHICAGO UNDERWRITING GROUP, INC.
191 N. Wacker Drive, Suite 1000
Chicago, Illinois 60606-1905

ADDRESS CORRECTION REQUESTED