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LAW

Executives' Good Luck in Trading Own Stock

By **SUSAN PULLIAM** and **ROB BARRY**

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A timely share sale by two insiders at retailer Body Central Corp. this spring spared them a nearly $1.4 million drop in the value of their holdings in the chain.

From left: Big Lots CEO Steven Fishman, Body Central Chief Merchandising Officer Beth Angelo and VeriFone Systems CEO Douglas Bergeron *BLOOMBERG NEWS*

Founder Jerrold Rosenbaum and chief merchandising officer Beth Angelo, his daughter, sold a combined $2.9 million of Body Central stock on May 1, May 2 and May 3. Later on May 3, after the market close, the company cut its 2012 earnings estimate. The next trading day, the stock plunged 48.5%.

A Body Central official said both executives' trades were part of preordained trading plans. The official said that Ms. Angelo set up a new plan for her father in March, a time when she wasn't aware of the trend that led to the lower estimate. The company

wouldn't make either one available for an interview. Mr. Rosenbaum, who the company said is ailing, resigned from the board in May.

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Corporate executives long have bought and sold shares of their own companies, and outside investors have long tracked such trades, in the belief that insiders have a particularly good feel for how companies are faring.

Executives can trade for entirely legitimate reasons, such as to raise money to meet a tax bill or simply to diversify. But of course they must avoid trading on nonpublic information, and that can lead to sticky situations, since executives do possess just such information much of the time.

TIMING IS EVERYTHING

Corporate executives can buy and sell their own company's stock but never based on nonpublic information. To avoid that issue, some set up prearranged '10b5-1' trading plans. Wall Street Journal research shows a number of executives, including some with 10b5-1 plans, have made highly beneficial trades shortly before their companies made market-moving news:

Regulatory efforts to find a way around this conundrum and allow executives to trade, a Wall Street Journal analysis suggests, are so flawed they have left a confusing landscape that can both raise suspicions about trades that are innocent, and provide cover for others that are less so.

The Journal examined regulatory records on thousands of instances since 2004 when corporate executives made trades in their own company's stock during the five trading days before the company released material, potentially market-moving news.

Among 20,237 executives who traded their own company's stock during the week before their companies made news, 1,418 executives recorded average stock gains of 10% (or avoided 10% losses) within a week after their trades. This was close to double the 786 who saw the stock they traded move against

them that much. Most executives have a mix of trades, some that look good in retrospect and others that do not.

The Journal also compared the trading of corporate executives who buy and sell their own companies' stock irregularly, dipping in and out, against executives who follow a consistent yearly pattern in their trading. It found that the former were much likelier to record quick gains.

Looking at executives' trading in the week before their companies made news, the Journal found that one of every 33 who dipped in and out posted average returns of more than 20% (or avoided 20% downturns) in the following week. By contrast, only one in 117 executives who traded in an annual pattern did that well.

"We've found a lot of evidence that these insiders do statistically much better than we'd expect," said Lauren Cohen, an associate professor of business administration at Harvard University who co-wrote a study published this year about the performance of insiders who time their trades. "The perch that they have—they not only have proximity to this private information, but they can actually affect the outcomes."

A Securities and Exchange Commission rule requires executives to report trades in their own company's stock within 48 hours. But getting a bead on trading by corporate executives has become more complicated, not less, in recent years, thanks to a proliferation of trading plans that provide for periodic buying or selling.

The arrangements, known as 10b5-1 plans, spell out certain times of the year, or certain target prices, when corporate executives intend to buy or sell shares of their own company. Executives who use such plans can trade even while they possess material nonpublic information about the company. And in the event they face suspicions of improper trading, having followed such a pre-established plan is a strong defense.

But the system has numerous shortcomings. Companies and executives don't have to file these trading plans with any federal agency. That means the plans aren't readily available for regulators, investors or anyone else to examine.

Moreover, once executives file such trading plans, they remain free to cancel or change them—and don't have to disclose that they have done so.

Finally, even when executives have such a preset plan, they are free to trade their companies' stock at other times, outside of it.

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"Sometimes a 10b5-1 plan is legitimate and other times it's not, but there is no way of knowing because there is no disclosure of anything to investors," said a hedge-fund manager, David Berman of Berman Capital Management.

The SEC, asked for comment on the plans' limitations, cited the requirement for insiders to report trades within two days and added: "If the Commission were to consider requiring insiders to make disclosure ahead of trades, there would need to be careful consideration of the costs and benefits."

The system leads to trading that is difficult to assess. Raymond Zinn, chief executive and

co-founder of semiconductor maker Micrel Inc., on several occasions had quick success in trades he made in Micrel shares just before Micrel made news.

On July 9 and July 12-24, 2007, Mr. Zinn sold a total of about $1 million of Micrel stock. On July 25, Micrel reported earnings at the low end of analyst expectations. The stock sank 22% in a single day.

Early the following year, Mr. Zinn bought about $800,000 of Micrel stock in the four days before Micrel put out an earnings news release saying the company hadn't been significantly affected by the slowing economy—and announcing that it would begin paying a dividend. Within a month, the shares Mr. Zinn purchased just ahead of this news were up 27%.

Mr. Zinn's timing was good again in early 2010. He bought about $295,000 of Micrel stock during the two trading days before Micrel executives made news at an investor conference by saying the company's business was improving. Within a month, the stock rose 36%.

Micrel said Mr. Zinn's 2007 stock sales were part of a 10b5-1 plan, the details of which the company said were confidential and declined to disclose.

His purchases in 2008 weren't part of such a plan, but they were "cleared in writing by Micrel's general counsel at the time because they were conducted after Micrel pre-announced for the quarter," a spokeswoman for Micrel said in an email. The spokeswoman didn't respond to questions about Mr. Zinn's 2010 trade.

Douglas Bergeron, CEO of VeriFone Systems Inc., set up a trading plan in January 2011 and then in late March sold nearly $14 million of VeriFone stock. In trades from March 28 to March 30, 2011, he received between $55 and $57 a share.

On April 5, VeriFone's stock began a long slide—exacerbated by a May 12 Justice Department lawsuit to block a VeriFone acquisition—that left the shares just above $30 in August.

A spokesman for VeriFone said the CEO didn't know that bad news was coming when he set up the trading plan in January. "Mr. Bergeron has always utilized a preset, fixed-formula trading program for his VeriFone stock transactions, regardless of the stock's performance, which has experienced multiple up and down cycles consistent with broader stock market performance in recent years," a spokesman said.

Jerrold Rosenbaum *FLORIDA TIMES-UNION*

The system of 10b5-1 plans sprang from a regulatory effort to address a perceived problem.

In 2000, the SEC—responding to court cases in which executives argued that although they possessed insider information, it hadn't influenced their trading—made a two-part adjustment in the rules for executives who trade their own company's stock.

First, for executives, the SEC further tightened its rule against trading on material nonpublic information. Going beyond this general rule, the SEC said that executives are barred from trading their company's stock whenever they possess such information, regardless of whether their trading is based on it.

However, the SEC simultaneously gave executives a way around this prohibition. In a tacit acknowledgment that insiders routinely possess private information that could move the stock, the SEC devised a method for them to trade in spite of it.

This was the system of 10b5-1 plans. Such a plan may state, for instance, that an executive will sell X number of shares on Day Y of every quarter, or will sell X number of shares whenever the stock hits Y price. Many different formulas are possible. The plans can be set up only at a time when an executive doesn't possess material nonpublic information about the company.

Such plans have become "ubiquitous" and now cover billions of dollars a year in trades by corporate executives, said Alan Jagolinzer, a business professor at the University of Colorado Boulder.

The rules have holes, Mr. Jagolinzer said, because the SEC doesn't require executives to disclose the plans' existence, their provisions or any changes made to them. Many companies do disclose the plans' existence, but they rarely disclose the provisions, since they don't want outside investors to be able to anticipate forthcoming trades.

The plans, instead of being filed with the SEC, are simply set up with a brokerage firm,

which is supposed to carry out automatically the trades specified.

Although executives must be free of material nonpublic information at the time when they set up such a plan, there is no rule about how long the plans must be in place before trading under the plans can begin.

The chairman and CEO of flooring manufacturer Mohawk Industries Inc. set up his 10b5-1 plan just six days before he started selling shares under the plan.

The executive, Jeffrey Lorberbaum, established his plan on March 9, 2006, according to his report to the SEC of his trades. On March 15, he began selling Mohawk shares through a family partnership, and sold about $10.4 million at various prices over the following two weeks.

On March 30—the day after his last sale—the company said it expected to report lower-than-expected earnings for the quarter. The next trading day, the stock fell 5.4%, its largest one-day decline in more than two years.

His sales at various higher prices spared Mr. Lorberbaum a drop of about $700,000 in the value of his Mohawk holdings. The stock price didn't recover for 11 months.

The company didn't return phone calls or emails seeking comment.

Executives can generally cancel a trading plan at any time. This includes times when they possess private information and when the cancellation of the plan's prescribed trades could benefit them financially.

Put another way, there is little in the system to prevent an executive who foresees good news about the company from canceling a scheduled share sale, or an executive who foresees bad news from canceling a scheduled share purchase.

In a 2009 study, Mr. Jagolinzer of the University of Colorado found that 46% of early terminations of 10b5-1 plans calling for share sales occurred within 90 days before the company released positive news, such as "best ever" quarterly profits, a new exchange listing, share buybacks or a regulatory drug approval. Canceling a sale before such news would allow an executive to obtain subsequent stock appreciation and avoid, in the common lingo, "leaving money on the table."

By contrast, Mr. Jagolinzer found that only 11% of the terminations of plans that called for share sales came before negative company news.

Executives also can amend trading plans, but only at times when they are free of material nonpublic information about the company.

Oil company Cobalt International Energy Inc. announced on July 27, 2011, that it had abandoned an exploratory well it was drilling off the coast of West Africa, and reported a quarterly loss. The news helped knock the stock down about 13% in two days and a total of 39% in nine trading days.

During the 12 trading days leading up to this negative report, Samuel H. Gillespie, co-founder and then general counsel, sold about $9.8 million of Cobalt stock. He sold nearly $3.8 million more on the day of the announcement and over the next two days.

A spokeswoman for Cobalt said Mr. Gillespie's sales were in accordance with a 10b5-1 plan, which he had amended sometime before the sales. She declined to say when he amended it but said in an email that the change was "in complete compliance with our procedures and had at least a minimum of 30 days before trades occurred."

The spokeswoman added that a "lockup" period barring stock sales had expired about 12 days before the earnings report, leaving Mr. Gillespie free to trade the company stock.

"I don't see how he would have possibly known about the well issue," the spokeswoman said, adding that this issue wasn't encountered until after Mr. Gillespie had begun selling. She described his trade timing as "coincidental" and "nothing notable."

One executive's trading plan set a target price for some of his sales that was too high to make it possible to sell. An amendment to the plan fixed this.

Ronald Delnevo, until recently managing director of U.K. operations for Cardtronics Inc., an automated-teller-machine company, sold 38,110 shares from Nov. 3 through Nov. 6, 2008. On Nov. 6, Cardtronics announced a quarterly profit of three cents a share rather than the 11 cents expected by analysts.

Cardtronics stock dropped 33% on the news, and continued tumbling in subsequent days. Shares that Mr. Delnevo sold for about $170,000 would have been worth only about $25,000 two weeks later, according to regulatory filings.

A spokesman for Cardtronics said the sales were part of a 10b5-1 plan that Mr. Delnevo had amended about two months before his selling.

Before the amendment, his plan called for some of his selling to be at $11 a share. With the stock well below this, he amended the plan so it allowed him to sell at whatever the

market price was.

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Mr. Delnevo waited 60 days after the board compensation committee approved this change before trading under the amended plan, the spokesman said, adding that his trades were "scheduled far in advance of Cardtronics issuing financial results."

Mr. Delnevo received an average of $4.44 for the shares he sold in early November, according to regulatory filings. By Nov. 21, a little more than two weeks after his selling, the stock collapsed to a closing price of 65 cents.

After the price fell, Mr. Delnevo became a buyer. He acquired 20,000 shares, outside of his 10b5-1 plan, as executives are free to do. The Cardtronics spokesman said Mr. Delnevo made his purchases during a window after earnings were released, when the company allows trading by its executives.

His average price for the shares he bought then was $1.26. The stock recovered, and he was a seller again nine months later at $6.61 a share.

Two weeks ago, Cardtronics reported the departure of Mr. Delnevo in a filing with the SEC. The company said it had no connection to his trading. Mr. Delnevo couldn't be reached for comment.

The CEO of retailer Big Lots Inc.—while not trading in the week before news, but a longer time before—has drawn flak from shareholders for a highly beneficial trade he made as this year's first quarter drew to a close.

The CEO, Steven Fishman, exercised stock options and sold a little over $10 million of Big Lots stock on March 20. On April 23, Big Lots surprised investors by disclosing that first-quarter sales had slowed.

The stock plunged 24% in a single day. That meant shares worth $10 million in late March, when Mr. Fishman sold, suddenly would have been worth $2.4 million less.

Mr. Fishman had a 10b5-1 plan calling for periodic stock trades, but he made this trade outside of the plan, as is permitted.

A Big Lots official said the trade was properly made "at a time when the company's trading window was open." The company noted that in the stock-options exercise, the

CEO paid about $5.3 million to buy the $10.3 million of shares that he sold.

Neither Mr. Fishman nor the company would comment on whether he knew of the sales slowdown when he sold the shares.

His trade displeased some shareholders, who had been primed for good news. Big Lots' guidance to investors in early March was for a 2% to 4% increase in sales. When the company on April 23 instead said to expect a decline, the stock fell by nearly a quarter in a single day, to $34. Mr. Fishman had sold at a little over $45.

In a lawsuit against Big Lots and Mr. Fishman, filed in U.S. District Court for the Southern District of Ohio, some shareholders allege they were misled about the state of the business even as the chief executive was selling shares.

The Big Lots spokesman said the sales were proper and declined to comment on the suit.

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