



Issue Commentary

10B5-1

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Background and Purpose

This past June, the SEC filed insider trading charges against former Countrywide Financial CEO Angelo Mozilo. Notably, the sales in question were executed pursuant to a 10b5-1 trading plan and they preceded substantial share-price declines. To the best of our knowledge, this is the first such case brought by the SEC.

In this *Issue Commentary* we briefly review the circumstances surrounding the charges brought against Mozilo. Additionally we look at the signs of potentially aggressive plan use that were present (and publicly available) at the time of the subject trades. Though the evidence reported to date is one-sided—the defense has not yet weighed in on the matter—we believe that certain details released in connection with the Mozilo investigation provide supporting evidence for our hypothesis that 10b5-1 plans are often used opportunistically to avoid anticipated future losses. It remains unclear whether these plans have, at times, been designed to enable executives to act opportunistically in response to material nonpublic information. Regardless, the results of recent academic research strongly imply that, in many instances, trades made within relatively more “aggressive” plans are unlikely to be entirely information neutral. Gradient’s own publication record also supports this theory, given the significant negative excess returns realized following our publications highlighting unusual 10b5-1 trading activity at 64 firms. These 64 firms generated average excess returns (relative to industry peers) of -4.5%, -6.6%, -10.5%, and -10.9% over periods of three, six, nine, and 12 months, respectively, from initiation.¹ Absolute returns over the same three, six, nine, and 12 month holding periods were -10.2%, -17.3%, -23.5%, and -24.3%, respectively.

In addition to reviewing the Mozilo case we also discuss a number of the characteristics we use to identify potentially aggressive plan sales. We close with a brief review of firms currently under coverage due (in whole or in part) to unusual 10b5-1 plan activity.

¹ All firms with 12-month measurement periods available were included. Firms covered too recently to have such measurement periods were excluded.



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Introduction

GRADIENT’S 10B5-1 RESEARCH GENERATES EXCESS RETURNS OF 6.6% (10.5%) IN THE SIX (NINE) MONTHS FOLLOWING PUBLICATION; HOW CAN THAT BE IF THESE PLANS ARE INFORMATION NEUTRAL?

Since 2005, Gradient has been covering instances of 10b5-1 plan sales with certain identifiable characteristics that we believe may be indicative of information-based trades. Our coverage has focused specifically on cases where the plans appear to have been used in a way that we believe runs contrary to the spirit of the rule. In this regard, our hypothesis maintains that these seemingly aggressive trading plans are more likely to be used to effect information-based trades.

The findings of academic research and abnormal returns realized after the publication of Gradient *Alerts* and other reports² identifying potentially aggressive 10b5-1 plan trades also imply that, on average, plans with more aggressive characteristics appear likely to have been used to effect information-based trades.³ In this regard, over the period 02/15/05 to 10/14/08⁴, Gradient highlighted a total of 64 firms where potentially aggressive 10b5-1 trading-plan activity was one of the primary factors driving our negative outlook. These 64 firms generated average excess returns (relative to industry peers) of -4.5%, -6.6%, -10.5%, and -10.9% over periods of three, six, nine, and 12 months, respectively. Absolute returns over the same three-, six-, nine-, and 12-month holding periods were -10.2%, -17.3%, -23.5%, and -24.3%.

Though the empirical results imply that at least some Section 16 filers are likely to have used their plans for information-based trades, it does not necessarily imply that the information underlying their trades would be considered “material nonpublic information,” as defined by law. For example, an executive with superior knowledge regarding his/her own firm (or industry-wide trends) could conceivably implement a plan based on concerns about future share-price underperformance without relying on material nonpublic information. On the other hand, if the plan were implemented while in possession of material nonpublic information regarding the onset of firm underperformance, then (at least in theory) the executive could be prosecuted for insider trading.

Notwithstanding the strength of the evidence regarding information-based trades within 10b5-1 plans, to date it appears that no Section 16 filer has ever been successfully prosecuted for trading on the basis of material nonpublic information for trades effected through a 10b5-1 plan. One reason for the lack of

² In addition to stock-specific *Alerts*, we have also published six prior *Issue Commentaries* on the subject, dated 03/07/08, 09/10/07, 09/06/07, 04/25/07, 04/23/07, and 05/03/06.

³ Jagolinzer, Alan D. “An analysis of insiders’ information-based trade within the SEC Rule 10b5-1 safe harbor.” (Stanford University, Graduate School Business, January 2005). Jagolinzer cautions against “generalizing the results” with respect to the trading activity that occurs within “nondisclosure firms” while also noting that his results “may understate the extent of 10b5-1 information-based trade by insiders at nondisclosure firms,” due to the reduced ability to monitor compliance. Jagolinzer also observes that generally, “participating insiders’ sales volume is positively associated with abnormal returns and is greater before ‘bad news’ earnings announcements than before ‘good news’ earnings announcements.”

⁴ The date of the most recent report published 12 months ago or later.





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successful prosecutions may be the fact that prosecutors must prove that an individual was in possession of material nonpublic information *at the time that the plan was put in place*. This could be particularly problematic when there is a reasonably long window of time between the date of plan implementation and the dates of any “suspicious-looking” plan sales. That is, as this window of time widens, it may be increasingly difficult for a prosecutor to determine whether an executive was actually in possession of material nonpublic information when the plan was put in place (or whether s/he was simply acting on the basis of “superior knowledge” regarding publicly available information).

Given the difficulties faced by would-be prosecutions, and the lack of successful prosecutions to date, it should come as no surprise that the use of 10b5-1 plans has grown significantly in recent years. We also believe that the absence of successful prosecutions may motivate *some* executives to act opportunistically when in possession of material nonpublic information. This appears to be the SEC’s argument with respect to the Mozilo case.⁵

The More Aggressive the Plan the Higher Risk?

DOES THE MOZILO CASE EXPOSE THE USE OF NONPUBLIC INFORMATION IN 10b5-1 TRADES? OR IS THE SEC PURSUING THE CASE FOR ITS HEADLINE VALUE?

This past June, the Securities and Exchange Commission filed securities fraud charges against former Countrywide Financial CEO Angelo Mozilo, former COO David Sambol, and former CFO Eric Sieracki for allegedly misleading investors about the significant credit risks being taken by the firm. Of greater interest for our purposes, the SEC also alleges that certain of Mozilo’s stock sales were based on material nonpublic information. What is significant about the latter charge is that Mozilo’s sales were made pursuant to four 10b5-1 trading plans. To the best of our knowledge, this action marks the first time that such charges have been levied against an executive who traded within a Rule 10b5-1 plan.

Though all available information about the Mozilo investigation is one-sided at this point—because the defense has not yet weighed in on the matter—the SEC has clearly stated that it believes the CEO’s actions were consistent with private knowledge about risks to the company. Perhaps more importantly, the SEC also alleges that this private knowledge (and stock sales) was *inconsistent* with assertions made to shareholders. In this regard, Robert Khuzami, director of the SEC’s Division of Enforcement, asserted that :

Countrywide portrayed itself as underwriting mainly prime quality mortgages using high underwriting standards. But concealed from shareholders was the true Countrywide, an increasingly reckless lender

⁵ What remains unanswered is the durability of the rule’s safe-harbor provision. Generally, as the headlines from the first SEC insider-trading case under Rule 10b5-1 fade, we expect executives’ use of the rule will continue unabated. Our observation is that the Mozilo case has not affected executive use of the rule, at least not to date.



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assuming greater and greater risk. Angelo Mozilo privately described one Countrywide product as ‘toxic,’ and said another’s performance was so uncertain that Countrywide was ‘flying blind.’⁶

Rosalind Tyson, Director of the SEC’s Los Angeles Regional Office, added that:

Angelo Mozilo had access to detailed and alarming information about Countrywide’s operations. *He knew that Countrywide was gambling with increasingly risky mortgages and he kept those details from investors while he was actively taking his own chips off the table.* [italics added for emphasis]

In commenting specifically on how the 10b5-1 trading plans were used by Mozilo to “take his own chips off the table,” the SEC noted that the CEO initiated four different plans over a three-month period from October to December 2006, while allegedly in possession of material nonpublic information (i.e., the knowledge that Countrywide was “gambling on increasingly risky mortgages”). These plans were then allegedly used to exercise more than 5.1 million options and sell all of the acquired shares for gross sales proceeds of approximately \$140 million over the period covering November 2006 to August 2007.

CHARACTERISTICS OF MOZILO PLANS REFLECT SEVERAL OF THE CRITERIA USED BY GRADIENT TO IDENTIFY POTENTIALLY AGGRESSIVE USE OF RULE 10B5-1

We found it interesting that a number of the factors used by Gradient to identify potentially aggressive 10b5-1 plan sales were also present in the Mozilo case. Two that stand out are (1) the use multiple plans and (2) the rapid sell-through of plan shares over a relatively short period of time. Our hypotheses regarding these two factors are as follows:

- **Use of multiple plans:** Other things equal, we hypothesize that executives will be more inclined to use multiple plans to effect sales that are information-based. The use of more than one plan may indicate greater urgency to sell shares and/or increasingly complex trading strategies used to effect sales.
- **Rapid sell-through:** Other things equal, we hypothesize that the rapid sell-through of plan shares is an indication of the urgency with which an executive wishes to reduce his/her exposure to firm shares. If nothing else, rapid sell-through certainly runs counter to the original spirit and intent of Rule 10b5-1.

⁶ Both quotations are from the 06/04/09 SEC press release regarding the charges.



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Other factors that we look for to assess the likelihood of information-based trades include:

- **Use of share-price triggers:** Other things equal, we hypothesize that the use of share-price triggers signals the executive's belief that shares are approaching fair value, or at least a near-term maximum price point. Accordingly, we believe these trades are more likely to be information-based.
- **Escalating sales levels as price increases:** As an extension of our hypothesis regarding the use of price triggers, we also view the escalation in number of shares sold as price increases to be a sign that, *ceteris paribus*, company shares may be approaching a potentially unsustainable high. As such, we believe such trades are more likely to be information-based.
- **Sales occurring during blackout periods:** *Ceteris paribus*, we also view 10b5-1 plans that allow sales to occur during typical blackout periods—such as in the days immediately surrounding the earnings announcement date—to be indicative of a more opportunistic mindset and/or the willingness to use loopholes to skirt typical internal controls over insider selling.
- **Large sales occurring immediately after plan implementation:** Other things equal, we view sales occurring immediately after plan implementation to be a sign of potential urgency to sell shares, and therefore may imply information-based trades.
- **Level of divestiture:** *Ceteris paribus*, we hypothesize that plan sales that account for a material portion of one or more executives' holdings are more likely to indicate urgency to sell, and therefore may imply information-based trades.
- **Clusters of plan sales by numerous Section 16 filers:** Lastly, we hypothesize that plan sales by a number of Section 16 filers over a relatively brief period of time (one quarter or less) as a sign that executives are concerned about either short-term event risk or valuation. As a result, we posit that these trades are more likely to be information-based—particularly if other factors (described above) are also present.

Active 10b5-1 Trading Plan Coverage

Table I lists the companies that we are actively covering (at least partially) as a result of what we deem to be aggressive use of Rule 10b5-1.

(See table, Companies Under Active Trading-Plan Coverage, *next page*)



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Table 1. Companies Under Active Trading-Plan Coverage

Ticker	Initiation Date
BMC	03/30/09
BSX	01/29/09
CMG	06/02/09
COL	07/17/09
DHR	07/22/09
DNDN	06/01/09
HITT	06/11/09
MHS	09/15/09
MPWR	07/28/09
TSRA	07/15/09



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