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DEALS & DEAL MAKERS

Directors Take Shelter in Trading Plans

By **SUSAN PULLIAM** and **ROB BARRY**
April 24, 2013 11:00 p.m. ET

Daniel Donoghue steamed across the squeaky wood floor of the exclusive Minneapolis Club last year. He had a bone to pick with the chairman of a medical-device maker.

Inside one of the ivy-covered club's private dining rooms, Mr. Donoghue, the company's largest investor, complained that amid a turbulent period at the company a member of the board of directors had unloaded most of the stake held by an investment fund he ran.

Daniel Donoghue criticized selling by a director of a firm he invested in. *CLAYTON HAUCK FOR THE WALL STREET JOURNAL*

The director's fund sold millions of dollars' worth of shares under a government-sanctioned plan that allows executives to schedule trades in advance to avoid suspicion of insider trading, but it was the size and speed of the sales that rankled Mr. Donoghue.

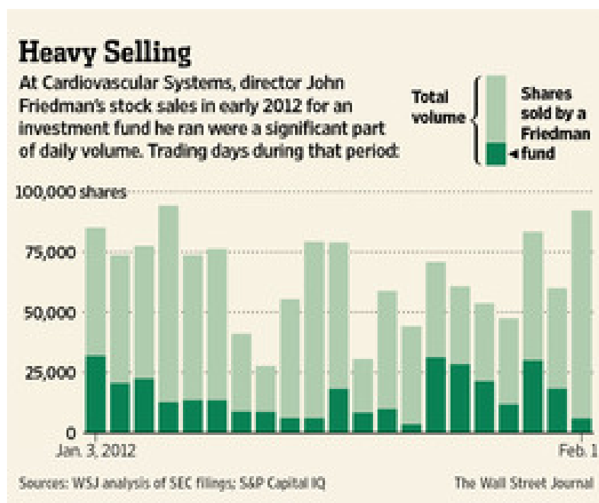
"Dumping an entire fund during a tumultuous earnings period is well outside the

bounds" those plans were designed for, he said.

These plans—opaque documents about which little is disclosed to regulators or the public—increasingly are moving beyond the executives for whom they were chiefly devised and finding favor with a different variety of insider: members of boards of directors, including some who run investment funds.

Nonexecutive directors' use of so-called 10b5-1 trading plans, which lay out future stock trades at set prices or on set dates, has jumped 55% since 2008, a Wall Street Journal analysis of regulatory filings found, exceeding a 36% rise among all other corporate insiders. The Journal identified 2,210 nonexecutive directors who reported using the schedules to sell stock since 2006.

And instead of selling a fraction of their shares at regular intervals, as envisioned when regulators created the plans as a way for executives to diversify their holdings, some directors use the plans to sell heavily in a short time.



From 2006 through 2011, nearly a quarter of nonexecutive directors with trading plans sold more stock in one month under the plans than in the surrounding two years, the Journal found. Some used 10b5-1 trading plans to unload all or the bulk of an investment fund's holding in a company, in a spate of selling.

The plans have drawn the attention of law enforcement. A federal prosecutor this week urged hedge-fund compliance executives to be vigilant about trading by directors who also run investment funds.

Patrick Sinclair, an assistant U.S. attorney in the Eastern District of New York, told attendees at a hedge-fund conference that a legal area "you might see coming down the pipe" involves instances where board members use 10b5-1 plans as a cover to trade out of stock positions amid bad corporate news.

"You as the compliance staff of your hedge fund should be aware of what that policy is and aware of whether or not it is enforced properly and whether or not your insider, your board member that you have control of, is following the rules internally," Mr. Sinclair said at the conference. "Whether or not you're satisfied with the adequacy of the

company's 10b5-1 plans, so that you're aware of it, so they can't be manipulated."

John Nester, a spokesman for the Securities and Exchange Commission, said it doesn't prohibit board members from using the plans to allow outside investment funds to trade shares. He added that this wasn't specifically contemplated when such plans were devised a dozen years ago to give executives a way to sell some shares of their own companies despite being exposed to nonpublic information about it. It is, he said, an "exotic permutation."

Others are more critical. The invention of trading plans "wasn't meant to facilitate fortuitous trades by investment funds," said Thomas Rohback, a partner at law firm Axinn, Veltrop & Harkrider LLP. "If you have someone who is a director on a company's board and he also runs some type of investment firm, he shouldn't be trading in that company's stock because of the appearance of impropriety, at the very least. It always appears he has an advantage over other investors."

Adam Epstein, a corporate-governance adviser, said that "the 10b5-1 rule created a safe harbor for executives from insider trading. Opportunistic trading is what they are trying to obviate. When you are an insider and you are trading opportunistically, why is filing a little form supposed to make me feel like you are complying with those rules?"

In one case, the fund a director worked for used a 10b5-1 plan to make a payment to an investor.

Antonio J. Gracias, the chief executive of a private-equity-fund operator called Valor Equity Partners LP, sits on the board of Tesla Motors Inc., a company in which Valor invests.

EARLIER: DARK MARKETS

The Journal is investigating a new age of murkiness in the financial markets and the challenges that creates for investors.

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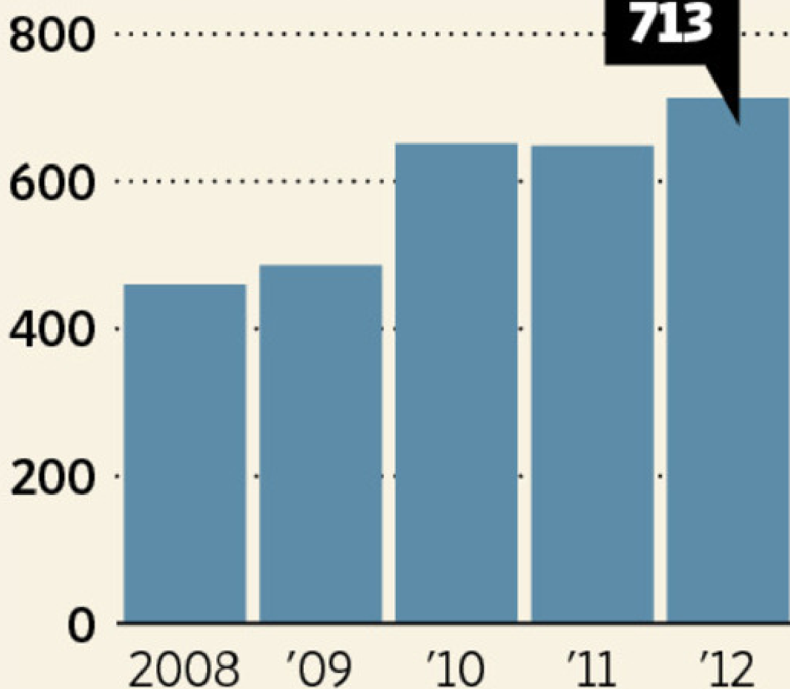
Valor set up a 10b5-1 plan in November 2011 and Mr. Gracias reported the sale of 927,205 of Valor's Tesla shares from March 9 through March 20, 2012, regulatory filings show. In those 11 days, Valor sold $32 million of Tesla stock, more than half its stake.



Tesla's stock price soon got hit. Another investor in the electric-car company—the investment arm of the Abu Dhabi Water and Electric Authority—sold about $100 million of Tesla stock on April 3. Within a week, Tesla's share price was 14.6% lower.

Valor sold an additional 29,800 Tesla shares in May, not reported as pursuant to a plan.

Tesla had been notified in February 2012 that the Abu Dhabi fund was considering selling a large amount of stock, according to Tesla and Abu Dhabi executives. A Tesla spokeswoman said the "clear impression" from the Abu Dhabi investor "was that they would sell no sooner than the end of the year."

Tesla Chief Executive Elon Musk said the Tesla board didn't know about the possibility of a sale by the Abu Dhabi fund until it sold its stock.

In an interview, Mr. Gracias of Valor said, "I didn't know that [the Abu Dhabi fund] was going to sell its shares, nor did my firm."

What Valor's trading plan said—how its terms resulted in the sale of so many shares in a short period—isn't public. There is no requirement to disclose the terms of trading

plans.

Even their existence often remains hidden, becoming known only if an insider mentions a plan while making a mandatory trade disclosure. Plans needn't be filed with the SEC.

Sometimes, directors disclose in filings that a fund they run or represent has amended an existing trading plan, but provide no explanation to the public.

That was the case at Double-Take Software, which adopted a "cautious stance" about its future financial results on Oct. 27, 2009, according to securities analysts' reports at the time.

Shortly before that, the company briefed board members on its business outlook, said a person familiar with the matter. Among those briefed, the person added, was Ashoke Goswami, a general partner of ABS Capital Partners, a Baltimore-based firm that invests in small, growing companies.

On Nov. 11, 2009, ABS amended a trading plan for Double-Take shares, a change Mr. Goswami disclosed in a regulatory filing. The director then reported the sale by ABS of $3.8 million in Double-Take stock, most of it under the revised plan, in trading from mid-December through Feb. 2, 2010.

On Feb. 3, Double-Take released earnings guidance below analysts' estimates. The stock plunged 21% in a day.

Mr. Goswami didn't return calls for comment. A spokesman for ABS said that the company issued guidance to investors and that neither Mr. Goswami nor any other partner "had any material, nonpublic information with respect to Double-Take" when the trading plan was set up and amended. ABS said it amended its plan "during an open window period for insiders to trade." Double-Take has since been acquired.

The trading that investor Mr. Donoghue complained about in an encounter at the Minneapolis Club offers an unusually detailed window into a director's use of a 10b5-1 trading plan to sell stock for an investment fund. It led to a monthslong spat involving him, the director, named John Friedman, and the company, Cardiovascular Systems Inc.

Mr. Friedman joined the company's board seven years ago when a private-equity firm where Mr. Friedman is a principal, Easton Capital Group, invested about $7 million in the Minneapolis-based medical-device maker.

In early October 2011, Cardiovascular had some negative news: Results for its just-ended

quarter would disappoint. Though the news hammered the stock, the shares recovered when the company said a few weeks later that it expected results to improve in the second half of its June 30, 2012, fiscal year.

On Nov. 30, 2011, Easton set up a trading plan for Cardiovascular stock. Under it, Mr. Friedman then reported the sale of 330,348 shares owned by one of his private-equity funds. The sales totaled $3.3 million and amounted to about 83% of this fund's Cardiovascular holdings.

His stock selling continued on every trading day from Jan. 3 through Feb. 1, 2012. During that time, it made up about 25% of the stock's trading volume, on average.

Six days after the end of Mr. Friedman's selling, Cardiovascular reported quarterly results that were below expectations and warned of a likely loss in the fiscal year. The stock declined slightly on the news.

Mr. Donoghue said he complained to an executive of Cardiovascular about what he called the "liquidation of John Friedman's fund in the midst of these negative events and prior to full market disclosure of the extent of the problems at the company."

On March 15, 2012, Mr. Donoghue said, he personally lodged a complaint during the meeting with Cardiovascular's chairman, Glen Nelson, at the elegant private club in downtown Minneapolis. He said he told Mr. Nelson he felt Mr. Friedman was "no longer qualified to represent the best interests of shareholders and that the board should replace him as soon as possible." Mr. Nelson declined to comment.

Mr. Donoghue sought an opinion from the outside counsel of Discovery Group, which is an investment fund he is a managing partner of and which is Cardiovascular's largest stockholder.

In an email to the counsel, Mr. Donoghue said he was concerned that "a considerable amount of significant new negative information was being learned by management and the Board" while a board member, Mr. Friedman, was selling the stock heavily.

"I am challenging the 'affirmative defense' " that 10b5-1 trading plans provide against any suspicion of improper trading, he wrote, "recognizing that these Plans are not safe harbors with respect to insider trading."

The Journal reviewed a copy of what Mr. Donoghue said was the response from the counsel for his fund: "I have never seen an institutional investor with a board

representative use a 10b5-1 plan to aggressively dump stock like this.... The dump it all nature of the plan makes one skeptical that the insider did not know more bad news was coming."

The counsel wasn't told of two points Mr. Friedman makes: that his fund needed to sell to repay a debt—and that another of his investment funds had retained its holding of Cardiovascular shares.

The fund that sold shares, Mr. Friedman said, needed to raise cash to repay a loan. Cardiovascular confirmed this, saying it agreed this fund needed to satisfy a debt and "allowed them to implement a 10b5-1 plan to sell their CSI shares.

Meanwhile, the other Easton Capital fund that invested in Cardiovascular continued to hold all of its shares, 421,000 in total, Mr. Friedman said. Filings confirmed this. Such a holding is worth about $7.6 million, reflecting an increase in the price of Cardiovascular's stock since the clash a year ago.

Insiders who use trading plans must be free of significant nonpublic information at the time when they set them up, and Mr. Friedman said he met this test. "We talked to company counsel to make sure there was no inside information and everything going on in the business was [publicly] known when we adopted the plan," he said.

"I didn't possess a single shred of inside information," he said.

Cardiovascular agreed that he didn't. It said in a statement that it "refutes any allegations of inappropriate insider trading by director John Friedman." It said the Cardiovascular board "believes that Mr. Friedman has complied with his fiduciary duties to the corporation."

Mr. Donoghue said he tried last summer to get Cardiovascular to dismiss Mr. Friedman from its board. He said the firm's chairman told him the board unanimously asked Mr. Friedman to resign but he chose not to.

Cardiovascular declined to comment on that, and Mr. Friedman wouldn't comment on whether he rejected a request from the firm to leave the board.

In January, Mr. Donoghue said, he was told by Cardiovascular's chairman that the company wouldn't communicate with him further.

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