Some CEOs Are Selling Their Companies Short

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For investors in Switch & Data Facilities, a telecom services startup, 2008 was a wild year. From a low of 8.60 in mid-March, shares more than doubled, to 18.17 three months later. Further gains seemed likely in late July when CEO Keith Olsen boosted the guidance he had given Wall Street analysts. But with revenue growth slowing even as debt payments and other costs jumped, Switch & Data was in the red by yearend. By November 2008, the shares had fallen to 4.21.

One shareholder avoided much of that drop: the CEO. On June 19, the day the stock peaked, Olsen contracted with an investment bank to hedge 150,000 shares—a quarter of his stock in the company—against losses if the price fell below 18. As part of the complex maneuver, he agreed to sell his shares to the bank one year later and got an advance of $2.2 million. Olsen, who disclosed his hedging in public filings, declined to comment for this story.

Hedges are ways to contain losses if a stock declines, while still keeping some upside potential if the price keeps rising (see table for a full explanation). It's a strategy anyone in the market can employ. But the way hedging is done by CEOs, directors, and other senior executives may deprive investors of clues about impending problems at companies. Many grant executives stock as compensation largely because they want them to have a stake in the company's success or failure. Investors routinely follow insiders' sales and purchases of company stock as a gauge of a corporation's prospects. Hedging, though, reduces an executive's exposure to stock price drops in a way that investors have a hard time detecting. The complex transactions are structured so that executives still technically own the shares. And though some really big hedges get noticed at the time they are made, disclosures of hedging are often vague or buried deep in the footnotes of obscure public filings.

"There is no question these transactions should be a red flag for investors," says Carr Bettis, the co-founder of forensic accounting firm Gradient Analytics and co-author of a recent study on hedging. "The evidence is pretty compelling that hedges tend to be used before bad news hits the market." Bettis' research found that in the year after executives and directors had engaged in hedging, their company's stock often dropped markedly. He also found evidence of an increase in financial restatements and shareholder lawsuits during the same period. Executives at MCI, Enron, ImClone, Krispy Kreme—companies that suffered some of the great stock melt-downs of the last decade—hedged their shares.

Some 107 instances of executive hedging were reported to the Securities & Exchange Commission in 2009, up from a decade low of 48 in 2007, according to Bettis, and regulators are beginning to scrutinize the transactions. Kenneth Feinberg, the U.S. Treasury pay czar, has banned executives from hedging at the banks and automakers that received government bailouts. "We wanted to make sure they couldn't undercut the links we created between compensation and long-term performance," says Feinberg. If executives at the companies could hedge their stock, he adds, "they wouldn't have to worry about how [the stock] does."

In 2000 and 2001, billionaire Philip Anschutz hedged shares of two companies in which he held major stakes, Union Pacific and Anadarko Petroleum. Shorting stock is typically done as part of

a hedging strategy. In Anschutz's case, the bank that arranged the deal, Donaldson, Lufkin & Jenrette (now part of Credit Suisse Group), shorted Anschutz's own shares rather than borrowing shares in the market to short. That was a common technique until tax authorities cracked down on it in 2006. In a case pending before U.S. Tax Court in Washington, the IRS is arguing that Anschutz's deals were effectively stock sales rather than hedges, and is seeking $143.6 million in capital gains taxes. Tax lawyers are watching the case because they say many other executives who early in the decade allowed their own shares to be shorted the way Anschutz did are now being audited. If the IRS wins its case, these hedgers could face big tax bills earlier than expected. Anschutz disputes the IRS's argument and would not comment for this story.

There are plenty of reasons a senior executive would hedge if he thought his company's stock was going to slide. In one type of hedge, called a prepaid variable forward contract, he can get a cash advance of up to 85% for shares he agrees to sell eventually to an investment bank. Because he still technically owns the shares, the IRS doesn't consider a hedge a sale so long as the bank doesn't short the executive's own shares. So the executive need not pay capital gains taxes until the hedge expires. Meanwhile, he can still vote the shares and collect dividends.

U.S. executive hedging first took off in Silicon Valley during the dot-com era, when transactions averaged around 290 a year. Investment banks—Morgan Stanley, Goldman Sachs, JPMorgan Chase, and Citigroup—rushed to provide hedge services. "I don't know of a bank that doesn't have a department doing this," says Mark Leeds, a tax lawyer with Greenberg Traurig. By mid-decade, he adds, transactions worth several billion had likely been sold. The hedge business helps the banks cement ties with top executives, which comes in handy when a bank is pitching other services. And the banks reap rich fees.

SUSPECT CORRELATIONS

Bettis and his co-authors examined 2,010 hedging transactions reported in filings by 1,181 executives at 911 firms between 1996 and 2006. In the year preceding executives' hedges, their companies' shares outpaced the market anywhere from 17% to 31% on average, depending on the type of hedge used, according to Bettis' analysis, which was completed last year. After the executives hedged, it's a different story. Shares in companies where the CEOs, directors, and other top executives had hedged using a variable forward sale lagged the market by 16.2%, on average. Those where a collar, another popular hedging transaction, had been used fell behind by 25%.

Roughly 11% of the companies where an executive used a collar had to restate financials within two years of the hedge transaction; comparable companies where no hedging occurred had half as many restatements, Bettis says. Some 11% of the firms that let their executives buy a variable forward contract faced securities-related suits within a year, double the number at companies that didn't hedge. "The poor performance following hedging suggests a number of these trades are potentially based on privileged information," argues Bettis. The trades "appear to be tied to events that were known or could reasonably have been anticipated by the executives," he adds.

SEC officials say executives who hedge fall under the same rules as those who sell their stock. If an executive were to use a hedge to protect himself against losses at a time when he possessed specific material information that the company's performance had stumbled or was about to, that could potentially bring an insider trading charge. But SEC spokesman John Heine says the agency has never pursued an insider trading case against an executive following a hedge.

Missed earnings in the wake of a hedge appear common, Bettis' research shows. Chattem Chairman and CEO Alexander Guerry placed a hedge on 60,000 shares of the Chattanooga (Tenn.)-based maker of Gold Bond foot powder, BullFrog sun block, and other products, according to public filings Guerry made with the SEC. The stock peaked at $81.45 on Feb. 13, 2008, the day after Guerry hedged. Within a month, data compiled by market researcher ACNielsen started to show weaker-than-expected sales. By June the stock was off 30%. Chattem President Robert Bosworth says Guerry's hedge, like four similar transactions he made since 2003, was meant to diversify his portfolio. The stock performed well after those earlier hedges, he points out; moreover, with less than 20% of Guerry's holdings hedged, Bosworth argues that Guerry was still exposed to the fall in share price.

Executives also have hedged shares just prior to the eruptions of some real messes. At Krispy Kreme in September 2003, a family partnership run by then-Vice-Chairman and Executive Vice-President John McAleer hedged 1.5 million of the doughnut chain's shares, receiving an advance of $50 million from its investment bank. The deal hedged against further losses if the shares dropped below $39.30. According to McAleer's public filings, that protection lasted on one tranche of 750,000 shares until September 2007, while a second tranche of 750,00 shares was protected against further downside until March 2008. At the time the stock was trading around 42. By November 2003, as questions mounted about earnings, the stock had started to drop. The SEC launched an investigation, Krispy Kreme restated earnings, and three executives eventually settled charges of securities fraud. When the second tranche of the hedge ended in 2008, the shares were trading at $2.59. McAleer, who was not cited in the SEC investigation, left the company in 2005; he was a defendant in a shareholder class action against the company and its former executives and directors that was settled in 2006 for $75 million.

McAleer's lawyer, Timothy Ehlinger, said in a written statement that the family partnership, which had been funded by stock inherited from his father, was advised by JP Morgan in early 2001 to diversify its holdings in the company's shares. The partnership hedged shares in September of 2001, 2002, and 2003 successively, according to plan. The fourth transaction, set for 2004, was cancelled. "Jack McAleer did not have any material nonpublic information regarding [the] stock," says Ehlinger. who adds that McAleer did not hedge any of the 500,000 shares he owned in his own name.

Bettis, who is also an associate research professor at Arizona State, readily acknowledges that it is impossible to know exactly what's behind any individual's trades by looking at public filings. Many executives say they hedge to diversify holdings heavily weighted toward their company's shares. "These deals are dictated by so much more" than what's happening at the company, says Robert Gordon, whose firm, Twenty-First Securities, sets up hedges. "I don't think people do them because they're bearish, but they do want to take some chips off the table." When Alan G. Hassenfeld hedged over 1 million shares before his 2006 retirement as executive chairman of toymaker Hasbro, for example, the company said the move was "to diversify his investment portfolio, realize liquidity...and provide funding against charitable pledges."

To track most hedges, an investor generally has to look up a Form 4, an SEC filing where top executives are required to report sales, purchases, and other transactions in the company's stock. Many details on hedges aren't actually listed in the two tables that make up Form 4. They show up instead in footnotes, and details are often incorrectly reported or missing, says Bettis. According to SEC regulations, companies must include such information as the exercise price of a hedge and the "dollar value locked in," the term of the transaction, and the number of shares

the executive would have at the end of the hedge. There's no mandated format, however, for conveying that information, which seems to have left companies unclear as to the requirements. Morad Tahbaz, a director of Air Methods, a provider of emergency medical travel, disclosed he was hedging 55,000 shares on Sept. 25, 2007. His filings didn't say how long his hedge lasted or what the floor price was beyond which he would be protected against a drop in the stock. The company says it believes it met all disclosure rules.

Chester Spatt, the SEC's chief economist from 2004 to 2007 who teaches finance at Carnegie Mellon's Tepper School of Business, believes details of hedges should be spelled out more clearly. "It's potentially misleading if a proxy says a guy owns 1 million shares but only has an economic interest in half that," says Spatt. Meredith Cross, director of the SEC's Corporate Finance Div., says the agency is starting several studies to see if disclosure rules are adequate. Still, she says, "shareholders have access to substantial information about executive hedging."

Some companies, including Procter & Gamble and Kellogg, ban executive hedging, but they are a minority. Lucian Bebchuk, head of the Program on Corporate Governance at Harvard Law School, predicts growing problems with hedges as companies make executives hold on longer to shares as a way of prodding them to work for long-term gains. A manager might have to keep a stock award for three years after it vests, for example. If he can hedge his shares and essentially cash out of them before the holding period ends, he eludes that restriction. That's why Bebchuk sees an all-out ban as the only solution. "Allowing executives the freedom to hedge," he says, "defeats the purpose of equity compensation."

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