

SOPHISTICATED INVESTOR

Letting loose the reins
Advanced strategies allow insiders to trade more freely

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SANTA MONICA, Calif. (CBS.MW) -- Insider trading always brings up difficult moral issues.

A recent Securities and Exchange Commission ruling may heighten the debate over the freedom -- or the fallacy -- of letting corporate insiders trade their company stock like every one else.

Dan Grant, a portfolio manager in the Private Investor Department at William Blair & Co. in Chicago conducted a survey that reveals companies are increasingly amending their insider trading programs to allow for more transactions.

Flexible rule

Last year, the SEC enacted Rule 10b5-1, which addresses insider trading liability issues.

"The rule provides a new level of flexibility for corporate insiders to have greater opportunity to buy and sell shares of company stock," Grant says.

Corporate insiders who trade their company's stock have had onerous oversight and compliance provisions from which to adhere. This greatly impinges their rights to trade as the general public.

Yet their discreet knowledge of company affairs can create an un-level playing field if they can trade as the general public does.

Moreover, insider trading is widely tracked by investment research firms and usually gauged as a negative indicator for stock direction. If a company is doing well, why would an insider sell?

The SEC sought to design a more fair approach to insider purchase and sale of company stock through its broader ruling, "Fair Disclosure."

Grant says the rule "enables insiders and issuers who establish a plan at a time when they are not in possession of material, non-public information to later execute predetermined trades even when such information exists, thereby relieving the pressure often felt by issuers to disclose information more quickly than planned.

"In addition, a properly executed 10b5-1 plan that is disclosed to the public can reduce the

negative implication of insider stock sales as perceived by market participants," he says.

In a broad corporate survey, Grant says 60 percent of the respondents now allow new insider trading plans.

This may be great progress for the tactical aspect of insider trading. But in a general sense, insider trading will still be a hitch.

"It just provides a safe harbor defense," Grant says.

Making intentions known

Under 10b5-1, executives must file written contracts of their trading intentions with a broker dealer. This allows them to execute trades while still being "aware" of nonpublic information. The SEC requires no public notification of the trading.

"Before 10b5-1, most courts went by 'use of knowledge' as proof of insider trading," explains attorney Jay Jackson at the Minneapolis-based law firm Dorsey & Whitney.

He says 10b5-1 expanded the definition of insider trading to "awareness" of nonpublic information. The written plan "safe harbor" was incorporated into the language because the term "awareness" is so broad -- and difficult to prove.

"The key [to proving insider trading] is 'when' did they acquire the knowledge," says Jackson.

This is really the crux of the insider trading dilemma, and the point 10b5-1 tries to clarify.

If an executive put in place a trade order and then acquired nonpublic information after that order but before it was executed -- is the trade allowable?

The written plan amendment by 10b5-1 would eliminate the seeming conflict of interest, Jackson says.

The timing of trading, of course, is still the tricky part.

Preplanned trading

To effectively allow executives to trade under Rule 10b5-1, Grant has devised two trading algorithms that create limit buy and sell orders.

These algorithms, The Stock Protection Algorithm and the Stock Spike Algorithm, automatically implement insider trades based on compliance and market criteria.

"And you can set limits so you don't have to lose upside," Grant says.

It should be noted that companies themselves have to adopt 10b5-1 plans; executives can still conduct insider trades without such a plan in place.

But with a broadened definition of what constitutes illegal insider trading, and with many companies disallowing insider trading altogether for weeks, or even years, a written trading plan of intent to buy or sell isn't such a bad idea. It can guard against innuendo.

"It's all a state of mind," Jackson says.

Now it will be a matter of determining whether what's written is true or not.

In the meantime, company executives can begin to trade their stock like the rest of us.

In this market, that may not be such a bonus.

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