

SEC Looks at How Insiders Use Exchange Funds

Technique Lets Big Investors Transfer Stock and Skirt Full Disclosure, Tax Bite

By RANDALL SMITH

Regulators and investors have assailed corporate insiders at companies such as Enron Corp. and Global Crossing Ltd. for bailing out of their company's shares during the market bubble, while less-informed shareholders were left holding the bag.

But many other insiders have for years routinely disposed of stock through a little-known vehicle called an exchange fund without clearly disclosing the action to investors.

The practice allows executives with large chunks of one stock to diversify their holdings, tax-free for a time, by transferring shares to an exchange fund, which pools them with other stocks owned by other big-league investors. Each exchange-fund investor winds up owning a stake in what resembles a mutual fund. No taxes are incurred immediately because the stocks remain in the fund instead of being sold

on the open market.

Now, the Securities and Exchange Commission is trying to learn whether dozens of corporate insiders used such exchange funds during the late 1990s to reduce their economic stake in their companies without raising a red flag to investors, according to people familiar with the probe. The agency suspects that numerous corporate insiders may have sold stock in the past six years without full disclosure to investors.

The current SEC inquiry expands a probe begun earlier this year into the possible use of certain derivatives, whose prices are derived from other securities, to obscure the disclosure of insider selling during the stock bubble of the late 1990s. At that time, as many companies went public, insiders who saw run-ups in the value of their stock wanted both to diversify single-stock holdings and lock in their gains, without alarming outside investors with a standard, immediate sale that would have had to be disclosed. The agency's look at the use



of exchange funds, which is part of the same overall effort, began this summer and could lead to tighter rules on disclosure.

Though tougher regulations now define when buying and selling must be disclosed, the requirements for making public such exchange-fund swaps remain murky. And that ambiguity could mean less information for investors who rely on disclosures of insider trades as barometers of how an insider feels about the company's prospects.

Using exchange funds "disadvantages" investors and "provides a vehicle for potential abuse" because shareholders might not realize executives are selling their stock, says Michael Painchaud, president of a Seattle research firm specializing in trades by corporate insiders.

The SEC, which declined to comment on the current probe, has contacted some of the companies where executives contributed shares to exchange funds in the period between 1996 and 1998, according to people familiar with the inquiry.

A case in point is William T. McConnell, former chief executive of Ohio bank Park National Corp. He wanted to dis-

Please Turn to Page A16, Column 3

Continued From First Page
pose of \$1 million of his company's stock without triggering immediate taxes or sending "a message to the stockholders that I had lost confidence" in the company, he says in an interview.

In October 1997, Mr. McConnell put 12,000 of his Park National shares in an exchange fund offered by Alex. Brown, now a securities unit of Deutsche Bank AG. In exchange, he got a stake in the fund. Around that time, he owned 185,000 shares of Park National.

Mr. McConnell, 70 years old, says he didn't intend to mislead shareholders. He says he reported the transaction to the SEC as a "nontaxable transfer into a limited partnership," as allowed by regulatory rules.

In July, the SEC asked Park National for information about any shares that Mr. McConnell had "transferred, pledged, conveyed or hypothecated"—another kind of pledge—to any exchange funds, including those formed by Alex. Brown going back several years, according to Daniel DeLawder, Park National's chief executive officer.

The bank provided the information about Mr. McConnell's exchange on July 16, Mr. DeLawder says. The SEC wanted to know how such an exchange had been reported, Mr. McConnell says.

(None of the executives named in this article have been accused of wrongdoing.)

Exchange funds for years had been viewed as a way for wealthy individuals to diversify their holdings by putting off any capital-gains tax they would accrue if they sold shares. Catering to well-heeled executives with at least \$5 million in assets and \$1 million in stock to be swapped, these funds were launched in the 1960s. They gained wider use in the late 1990s, when the dot-com bubble boosted the net worth of corporate executives based on the value of their company stock. Though investing in such funds has waned since the tech bubble burst, there is still about \$20 billion in exchange-fund assets, according to specialists, with as many as 1,000 corporate insiders invested in them.

Exchange-fund participants can't dodge capital-gains taxes indefinitely. When they are ready to liquidate, they typically receive a basket of stocks from the fund, with its value based on the performance of the entire fund since the investor's original exchange. But as long as they stay in the exchange fund for seven years or longer, investors don't owe taxes until they sell the individual stocks.

The largest exchange-fund operator is Eaton Vance Corp., which accounts for about \$10 billion of total exchange-fund assets. Other large sellers of the funds include Goldman Sachs Group Inc., J.P. Morgan Chase & Co. and Merrill Lynch & Co.

Neither the SEC nor the courts has specifically determined that putting stock into an exchange fund constitutes a sale. Such exchange-fund swaps must be reported by corporate insiders, but the report format is ambiguous on using the word "sale." Transactions must be labeled either "acquisitions" or "dispositions"; but the category of dispositions may be labeled either "sale" or "other." Many insiders such as Mr. McConnell labeled their exchanges as "other," describing them only in vague terms and not as an outright "sale" that would be likelier to be picked up in the databases kept by services that track insider buys and sales.

Still, "there are others who would take the position that if I'm surrendering my shares to a fund, and getting an interest in the fund, I'll report it as a sale," says Peter Romeo, who specializes in reporting insider transactions at the Washington law firm of Hogan & Hartson LLP.

Some executives say they have disclosed their exchanges as sales, to avoid an appearance of abuse. Ralph Glasgal, the former chairman and president of Glasgal Communications, says he didn't regard his 1997 exchange of \$1.3 million in corporate stock as a sale, but that a lawyer advised him to report it that way. "It's a matter of opinion," Mr. Glasgal says. "You could argue it both ways."

Mr. Glasgal, who contributed 160,000 Glasgal Communications shares valued at \$1.3 million to an Alex. Brown exchange fund, disclosed the transaction as a sale of 160,000 shares in October 1997, according to Thomson Financial. The Rockleigh, N.J., resident retired the following year; Glasgal, which provides information-technology services, changed its name to Datatec Systems Inc. in 1998 and is based in Fairfield, N.J.

Yet a number of corporate insiders haven't treated their exchange-fund deals as an outright sale. They believe this is totally proper, in keeping with regulatory rules. Among them is Ronald B. Stakland, a former senior vice president of Telegroup Inc., who contributed 100,000 Telegroup shares with a market value of \$1.3 million to an Alex. Brown exchange fund without disclosing the transaction as a sale. Shortly after the transaction, Mr. Stakland left the company, which sought bankruptcy-law protection from creditors in 1999 and later was delisted.

"I had the whole thing thoroughly reviewed by attorneys and accountants," Mr. Stakland says.

Mr. DeLawder, who succeeded Mr. McConnell as chief executive of Park

National in January 1999, says the form of the disclosure in Mr. McConnell's case wasn't designed to keep the transaction out of the database tracking purchases and sales. "That's not our game," he says. "That's absurd." The disclosure of the transfer into the limited partnership "put the world on notice" of what was happening, he adds.

For Mr. McConnell, his \$1 million in shares became part of a \$132.7 million fund assembled from contributions by 82 investors. Because Mr. McConnell reported the transaction as a "nontaxable transfer into a limited partnership," investors searching Thomson Financial's database of buying and selling by such corporate insiders at Park National would see only buying by Mr. McConnell, in three separate purchases, for the years 1995 through 1999.

Anthony Marchese, who manages \$30 million in the Insiders Trend Fund L.P., a fund that invests based on insider buying and selling patterns, says it's "not really fair" to investors to allow insiders to sidestep disclosing such transactions as sales. "If you swapped out of your stock into something else, that should be reported as a sale. I would be in the camp that says, 'I want to know. Give me the information, and let me figure out whether it's meaningful to me.'"