

UNITED STATES DISTRICT COURT  
FOR THE DISTRICT OF COLORADO

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UNITED STATES OF AMERICA,

Plaintiff

v.

JOSEPH P. NACCHIO

Defendant.

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) **Crim. No. 05-cr-00545-MSK**  
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**REBUTTAL REPORT OF ANJAN V. THAKOR**

1. My name is Anjan V. Thakor, and I am the John E. Simon Professor of Finance and Senior Associate Dean at the John M. Olin School of Business at Washington University in St. Louis.<sup>1</sup> On November 23, 2009, at the request of the United States Department of Justice (“Department of Justice”), I submitted a report in relation to Mr. Nacchio’s re-sentencing. In that report, I estimated Mr. Nacchio’s gains, or losses avoided, stemming from sales of Qwest stock that he made between April 26, 2001 and May 29, 2001, while in possession of material, nonpublic information. Mr. Daniel Fischel, working on behalf of counsel for Mr. Nacchio, also submitted a sentencing report on November 23, 2009.<sup>2</sup> The Department of Justice has asked me to review Mr. Fischel’s report and to clarify the similarities and differences between Mr. Fischel’s report and mine.

2. In evaluating the two reports, I begin with a discussion of the framework for our respective analyses, or the question that we both seek to answer. I then examine differences in our analyses, including: (1) the identification of relevant disclosure dates; (2) the statistical approaches we adopted; and (3) the measures of broad market controls in the two reports. I close with a summary assessment of the two reports in light of these differences.

3. To begin, I discuss the purpose of our respective analyses. According to the Tenth Circuit, the Court’s assignment is to calculate “a figure that reflects, in at least approximate terms, the proceeds related to [Mr. Nacchio’s] criminally culpable conduct (i.e., trading on material, nonpublic information.)”<sup>3</sup> In order to estimate the gains stemming from Mr. Nacchio’s trades on material, nonpublic information, both Mr. Fischel and I have attempted to measure what Qwest’s stock price would have been at the time of the trades, had Qwest made appropriate disclosures relating to its levels of recurring and non-recurring revenues, and their implications for the company’s future revenue growth.<sup>4</sup> The difference between what the stock price would have been, had the information been disclosed, and the prices at which Mr. Nacchio actually sold his shares, represents Mr. Nacchio’s ill-gotten gains. In order to determine what the stock price would have been, Mr. Fischel and I both consider the stock price

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<sup>1</sup> For further detail regarding my credentials, publications, testifying experience and specific analyses, please refer to my expert report filed November 23, 2009 (“Thakor Report”).

<sup>2</sup> It is my understanding that Mr. Fischel also submitted a report on July 2, 2007 in relation to Mr. Nacchio’s initial sentencing. Hereafter, I will refer to that report as Mr. Fischel’s “Original Report,” and to his November 23, 2009 report as his “Re-Sentencing Report.”

<sup>3</sup> See, Appeal from the United States District Court for the District of Colorado (D.C. No. 05-CR-545-K), at 14.

<sup>4</sup> Specifically, Mr. Fischel stated that his “sentencing report was prepared to estimate the portion of Mr. Nacchio’s sales proceeds during the Insider Trading Period that could be attributed to inside information concerning (i) Qwest’s ability to achieve results consistent with its financial guidance for 2001, and (ii) the magnitude of Qwest’s IRU transactions.” (Fischel Re-Sentencing Report, ¶1) The significance of Qwest’s IRU transactions lies in their relevance to the levels of recurring vs. non-recurring revenues.

reactions when the previously-undisclosed information about Qwest's levels of recurring and non-recurring revenues was revealed to the public. The stock price reaction, controlling for broad market and industry effects, and unrelated company news, represents the "value" of the new information. By measuring the value of the information that was not disclosed at the time of Mr. Nacchio's sales, and subtracting it from Mr. Nacchio's sales prices, both Mr. Fischel and I arrive at a measure of the proceeds related to Mr. Nacchio's criminal conduct.

4. However, although Mr. Fischel and I appear to be working with similar goals for our analyses, I have identified several key differences in our analyses that have led to disparate results.<sup>5</sup> First, Mr. Fischel and I have performed our respective analyses on the stock price reactions to different disclosure dates.<sup>6</sup> Without explanation, Mr. Fischel did not include the dates of several key disclosures, including: (1) June 20, 2001, when a Morgan Stanley Dean Witter analyst report downgraded Qwest's shares because of concerns over premature revenue recognition on the part of Qwest; (2) September 27, 2001, when CalPoint disclosed an earlier swap transaction with Qwest, which analysts claimed revealed Qwest's non-recurring revenue and inflated growth rate; (3) October 31, 2001, when Qwest announced disappointing earnings and attributed it to a decline in previously-undisclosed IRU transactions; (4) February 13, 2002, when the Wall Street Journal identified four more swap transactions that generated non-recurring revenue and inflated Qwest's growth rate; and (5) July 29, 2002, when Qwest announced that it expected to restate its past financials due to premature revenue recognition related to IRU transactions. In my earlier report, I have explained why these dates are relevant disclosure dates to examine. Mr. Fischel does consider the August 22-23, 2001 dates that I examined in addition to dates above, but by failing to consider the stock price reactions on the other dates listed above, Mr. Fischel has considered only one small part of the value of the inside information Mr. Nacchio possessed at the time of his sales.

5. Furthermore, Mr. Fischel has analyzed one date, September 10, 2001, that I do not examine. This date involves a disclosure that engendered a price reaction unrelated to the inside information that Mr. Nacchio possessed at the time of his sales. On that date, Qwest lowered its

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<sup>5</sup> I have estimated Mr. Nacchio's ill-gotten gains as at least \$24,131,502.73, and possibly \$33,804,906.84. In his original report, Mr. Fischel concluded that "the portion of Mr. Nacchio's sales proceeds that can be attributed to inside information is \$1,832,561." (Fischel Original Report, ¶6) In his re-sentencing report, Mr. Fischel claims that Mr. Nacchio "did not avoid any losses by selling stock prior to these disclosures," implying that his gains from insider trading are zero (Fischel Re-Sentencing Report, ¶¶2, 6, 7, 8).

<sup>6</sup> In fact, Mr. Fischel has considered different disclosure dates between his original report and his re-sentencing report. Specifically, he included Qwest's July 24, 2001 earnings announcement and conference call in his original report (Fischel Original Report, Exhibit 2), but he did not include that date in the analysis in his re-sentencing report and did not provide a justification for this change (Fischel Re-Sentencing Report, ¶5).

guidance for the remainder of 2001 and 2002, and announced that it was laying off 4,000 employees. In light of the cost-cutting and cash-retaining measures, Qwest's stock price rose 9% on the date of the announcement. However, this disclosure is not relevant to the value of the information Mr. Nacchio held at the time of his insider trades; the price response to Qwest's cost-cutting measures must be separated from the measure of the value of Mr. Nacchio's inside information. To see why this date should not be included, three facts should be considered. First, when a firm lowers its earnings guidance, we would generally expect a negative price reaction. However, if the price reaction is *positive*, it may indicate that the market had expected the revised earnings estimate to be actually *lower*, and the actual earnings guidance was not as bad as the market expected. In that case, the lowered earnings estimates would have already been incorporated into the share price prior to the company's disclosure, and an event study on the company's disclosure date would not capture the value of that information. Second, even if Qwest's lowered earnings guidance was unanticipated bad news, this bad news may have been more than offset by the good news contained in the cost-cutting measures announced *at the same time*, leading to the positive price reaction. Third, there is no reliable way to separate the effect of the good news embedded in the cost-cutting measures from the news (whether it was perceived as positive or negative) contained in the lowered earnings guidance. When one considers all these factors together, one sees that including the September 10, 2001 date in the event study violates an important condition for reliable event studies, namely the exclusion of dates that suffer from a commingling of unrelated contaminating news with the information disclosure whose impact one wishes to study. Thus, by improperly including this disclosure date, Mr. Fischel has tainted his measurement of the value of Mr. Nacchio's inside information.

6. In addition to the identification of relevant dates, Mr. Fischel and I have performed differing statistical analyses in our reports filed November 23, 2009. In my report, consistent with Mr. Fischel's original report, I employed a rigorous, scientifically-approved regression methodology known as an event study.<sup>7</sup> In the event study, I performed multiple regression analysis to control for broad market and industry effects, and company-specific information unrelated to the charges in this case, in order to isolate the relevant price movements.<sup>8</sup> Essentially, the regression component of an event study uses historical data to measure the degree to which a firm's stock price return is explained by price movements in the broad market and price movements in the industry. These statistical estimates are then applied in subsequent time periods to the observed returns on the market and industry to calculate the expected return on the stock attributable to the observed returns on the market and industry index. Subtracting this calculated return from the actual observed return on the stock gives us

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<sup>7</sup> For more information on the event study, see Thakor Report, footnote 3. See also, Fischel Original Report, footnotes 10 and 11.

<sup>8</sup> See, Thakor Report ¶¶12-16, 26-39.

the “abnormal return,” which is the portion of the return that is unrelated to broad market or industry movements. This is the standard approach in academic research for computing the price effect of specific information disclosures that is distinct from the effect other factors, such as the market or the industry.<sup>9</sup> Mr. Fischel performed similar event study analysis, controlling only for the broad market, in his original report.<sup>10</sup> However, in his re-sentencing report, Mr. Fischel did not even provide an event study. Instead, he claims to perform an analysis that “take[s] into consideration unrelated negative market and industry developments but do[es] not require the estimation of a regression model or other statistical analysis.”<sup>11</sup> Essentially, Mr. Fischel’s analysis implicitly assumes—without support—that each one percent movement in the NASDAQ Telecom Index explains a one percent movement in Qwest stock. This is empirically unjustified. Moreover, in his analysis, Mr. Fischel also fails to explicitly control for broad market factors as well as other company-specific factors unrelated to the charges in this case. In my opinion, the event study methodology, such as that specified in my report, is superior to this approach in Mr. Fischel’s re-sentencing report because it explicitly incorporates a scientific approach to isolating the price impacts of material, relevant public disclosures of previously private information, as stipulated in the Tenth Circuit’s guidelines.

7. Finally, I note a discrepancy between the indices that Mr. Fischel and I have used to control for broad market and industry factors. In his original report, Mr. Fischel controlled only for the broad market, using the NASDAQ Composite Index.<sup>12</sup> In his re-sentencing report, he employed only an industry control, the NASDAQ Telecom Index.<sup>13</sup> I have employed both a broad market control (the New York Stock Exchange Composite Index) as well as an industry control (the American Stock Exchange North American Telecommunications Index).<sup>14</sup> This means I have explicitly controlled for both market and industry-related events—both of which

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<sup>9</sup> See, e.g., Cornell, Bradford and R. Gregory Morgan, “Using Finance Theory to Measure Damages in Fraud on the Market Cases,” *UCLA Law Review* 37-883, June 1990; Mackinlay, Craig A., “Event Studies in Economics and Finance,” *Journal of Economic Literature* 35, March 1997, pp. 13-39; and Mitchell, Mark, L. and Jeffrey M. Netter, “The Role of Financial Economics in Securities Fraud Cases: Applications at the Securities and Exchange Commission,” *Business Lawyer* 49-2, February 1994, pp. 545-590.

<sup>10</sup> See, Fischel Original Report, ¶¶8-14.

<sup>11</sup> See, Fischel Re-Sentencing Report, ¶3.

<sup>12</sup> See, Fischel Original Report, ¶10. The NASDAQ Composite Index is a broad-based capitalization-weighted index of stocks in all three NASDAQ tiers: Global Select, Global Market and Capital Market. (Source: Bloomberg)

<sup>13</sup> See, Fischel Re-Sentencing Report, ¶4. The NASDAQ Telecommunications Index is a capitalization-weighted index designed to measure the performance of all NASDAQ stocks in the telecommunications sector. It is currently comprised of 161 companies. (Source: Bloomberg)

<sup>14</sup> See, Thakor Report, ¶33. The NYSE Composite Index is a float-adjusted market cap weighted index which includes all common stocks listed on the NYSE. The AMEX North American Telecommunications Index is an equal-dollar weighted index of 16 U.S., Mexican, and Canadian companies that are involved in telecommunications-related services or manufacturing. (Source: Bloomberg)

are unrelated to Mr. Nacchio's inside information about Qwest—in computing the portion of Qwest's price movement that can be attributed to Qwest-specific private information, which I believe is consistent with the Tenth Circuit's guidelines. While the differing choices in indices account for only a small portion of the difference between Mr. Fischel's findings and mine, I note that this is another discrepancy.

8. In conclusion, I find that although Mr. Fischel and I appear to agree on the objectives for our respective analyses, differences in implementation lead to disparate results. There are three main reasons for the different results: (1) Mr. Fischel uses the NASDAQ Telecom index to represent industry movements and assumes (without support) that Qwest's stock price should be expected to move by the same percentage by which the NASDAQ Telecom index moves, whereas I use regression analysis to compute the expected portion of Qwest's return that can be explained by telecom industry movements; (2) Mr. Fischel ignores the effect of broad market movements, whereas I account for these; and (3) Mr. Fischel ignores relevant information disclosure dates that I analyze and includes an improper date that I exclude. It is my opinion that these weaknesses in Mr. Fischel's analyses lead to an unreliable estimate of losses avoided.

Respectfully,

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Anjan V. Thakor

Date signed: