IN THE UNITED STATES DISTRICT COURT
FOR THE DISTRICT OF COLORADO

Criminal Case No. 05-cr-00545-MSK

UNITED STATES OF AMERICA,

Plaintiff,

v.

1. JOSEPH P. NACCHIO,

Defendant.

SENTENCING STATEMENT BY THE UNITED STATES REGARDING GAIN AND FORFEITURE

The United States respectfully submits its Sentencing Statement regarding gain and forfeiture. A table of contents is provided on the following page.

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An exhibit list is included as the last exhibit.

The Government submits this Sentencing Statement on the issues the Court has identified as Phase I issues: gain and forfeiture. The Government submits that the gain can be calculated alternative ways, but is at least $32.9 million. The Government stipulates to a forfeiture amount of $44,632,464.38.

I. THE GOVERNMENT REQUESTS A BIFURCATED APPROACH TO SENTENCING.

In its Order Regarding Resentencing (Docket #584), the Court ordered the parties to include in their sentencing statements their positions regarding certain sentencing procedural issues. The parties have conferred and will file a joint pleading contemporaneous with their sentencing statements stating areas where the parties agree. In addition to that joint filing, the Government responds as follows to the Court's questions (*see* Docket #584 at 9):

Bifurcated phases: The Government agrees with the Court that bifurcating the two phases of the resentencing has advantages. The Government would like to "reflect upon determinations made" with respect to the gain calculation prior to filing its brief related to 18 U.S.C. § 3553(a) as suggested by the Court. Docket #584 at 9.

Hearings: As stated in the joint pleading filed today, the Government (along with the defense) believes that the Court can decide the gain issue without conducting an evidentiary hearing. Both parties have had experts conduct event studies, which they are attaching to their sentencing statements. The principal difference between the parties' event studies relates to the disclosure dates, *i.e.*, which disclosures should be considered as relating to the inside information at issue. Resolution of this issue is within the scope

of the Court's authority and competence. The Government believes that the Court can resolve that issue based on the papers submitted, without a hearing.

As for the resentencing hearing, the parties believe that a resentencing hearing should take no more than half a day.

Schedule for filing § 3553(a) briefs: As stated in the joint pleading, the Government and the Defendant request leave to, and will be prepared to, file their briefs addressing 18 U.S.C. § 3553(a) within 10 days of the Court's determination of the gain amount.

Other issues. Finally, the Government notifies the Court that it does not seek to address any matters other than gain and forfeiture in conjunction with the Phase I determinations.

II. THE PARTIES HAVE STIPULATED TO THE FORFEITURE AMOUNT.

The Tenth Circuit remanded for a recalculation of the forfeiture amount. *United States v. Nacchio*, 573 F.3d 1062, 1088-90 (10th Cir. 2009). In doing so, it "express[ed] no opinion on whether the costs to exercise the options should be deducted alongside brokerage fees as the district court can revisit that issue in recalculating the forfeiture amount under the proper provision." *Id.* at 1090 n.27.

The parties have stipulated that the proceeds subject to forfeiture, based upon the jury's guilty verdicts on Counts 24 through 42 and based on the based on the Tenth Circuit's opinion, amount to $44,632,464.38. The parties are submitting a stipulation

today. The stipulation includes a calculation, which shows that deductions have been made for both broker fees and options costs.[1]

III. AS TO GAIN, THE TENTH CIRCUIT ADOPTED A BURDEN-SHIFTING DISGORGEMENT APPROACH.

As to gain, the Tenth Circuit recognized that the applicable guideline, U.S.S.G. 2F1.2 (2000), provides for a calculation of "the gain resulting from the offense." The court then held that the Defendant's gain must be one that "reflects, in at least approximate terms, the proceeds related to his criminally culpable conduct (i.e., trading on material, nonpublic information)." 573 F.3d at 1069. The court explained that even after disclosure of the inside information, a stock still has value. *Id.* at 1071-73.

After extensive discussion, the court of appeals "specifically conclude[d] that the civil disgorgement remedy provides an appropriate guidepost for sentencing in criminal insider trading cases." *Id.* at 1072. That approach is discussed below.

A. The Tenth Circuit adopted a straightforward disgorgement approach.

The disgorgement approach is a method for determining the value of the stock after disclosure of previously-undisclosed inside information. It "sets a logical, temporal cutoff point for assessing the gain of the illegal conduct, *i.e.*, the point when the information is disclosed and absorbed by the market." *Id.* at 1082.

The Tenth Circuit outlined how a court should calculate disgorgement. It presented a hypothetical where an insider sells stock at $35 per share, but "[w]hen the information is ultimately disclosed and absorbed by the market, the company's stock price

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[1] In accordance with the applicable statute, 28 U.S.C. § 2461(c), and the Tenth Circuit's opinion, the Government respectfully requests that this amount be characterized as a forfeiture, rather than restitution, which is a distinct remedial concept.

drops to $5 per share." The court explained, "Under our disgorgement approach ... we typically would subtract the price of the stock when the information was disclosed and absorbed by the market (*i.e.*, $5) from the sales price of the stock (*i.e.*, $35 per share) and multiply by the number of shares." *Id.* at 1084 n.22. The court thus would not consider the stock worthless, but "would take into consideration the value of the stock after the information was disclosed and absorbed by the market – that is, the $5 stock price." *Id.* at 1085.

As described above, this disgorgement calculation involves four steps: (1) determine the price at which the defendant sold, (2) determine the date on which the information was ultimately fully disclosed and absorbed by the market, (3) determine the difference in price, and (4) multiply by the number of shares sold.

Put another way, disgorgement essentially involves two main steps. First, the court must determine the date when the information was absorbed by the market. Second, it must determine the difference between (a) the total amount the Defendant received when he sold, and (b) the total amount the Defendant would have received if he had sold on the date the information had been absorbed into the market (*i.e.*, the shares sold times the stock price on that date).

The key determination is the end date — *i.e.*, the date on which the information has been disclosed and absorbed. The Tenth Circuit made clear that in selecting the end date, the district court "will be afforded considerable discretion." *See U.S. SEC v. Maxxon*, 465 F.3d 1174, 1179 (10th Cir. 2006) (explaining that in calculating disgorgement, it is sufficient that "the end date chosen results in a reasonable approximation of illegal profits") (internal quotation marks omitted) (quoted in *Nacchio*,

573 F.3d at 1080); Bromberg, Securities Fraud, § 6:338 at 6-898 (explaining that "[t]here is considerable variability in determining what is a reasonable time after disclosure") (quoted in *Nacchio*, 573 F.3d at 1080). The Tenth Circuit observed that the Supreme Court has not adopted "any particular theory of how quickly and completely publicly available information is reflected in market price." *See Nacchio*, 573 F.3d at 1080 (quoting *Basic, Inc. v. Levinson*, 485 U.S. 224, 248 n.28 (1988)).

B. The Tenth Circuit gave the Defendant the burden to prove that the price decline was caused by unrelated factors.

The Tenth Circuit noted that in calculating disgorgement, a defendant must be given an opportunity to separate out factors unrelated to the material nonpublic information at issue. But the Tenth Circuit made clear that these factors should be separated out only if it can be shown to a sufficient degree of certainty that the factors were actually unrelated to the information at issue. It explained that the district court should exclude the effects of "unrelated negative industry developments," but only "[t]o the extent that the stock-price effects of those negative developments could be isolated with sufficient certainty." *Id.* at 1085. *See also SEC v. First City Fin. Corp.*, 890 F.2d 1215, 1232 (D.C. Cir. 1989) (*en banc*) (in applying a disgorgement approach, declining to separate out the price effects of various disclosures because the other events were not shown to be "independent" of the disclosure at issue).

The Tenth Circuit made clear that it is the *defendant* who has the burden to show that these unrelated factors had an effect on the stock price. The court said it could "safely assume" that the defendant "would bear the evidentiary burden" to "isolate with a

sufficient degree of certainty the stock-price effects of the unrelated negative industry developments." *Nacchio*, 573 F.3d at 1086 n.23.

The Tenth Circuit thus gave the defendant two burdens: (1) to show that other factors were unrelated, and (2) to isolate their effects. Only if the defendant meets both burdens — *i.e.*, identifying the other unrelated events, and showing clearly what effect they had — does the court then exclude the effects of those factors. *Id.* at 1086 n.23 (explaining that a district court could seek to exclude the effects of unrelated factors "where unrelated events can be identified and it is clear that they have affected the stock price"). *See also First City Fin. Corp.*, 890 F.2d at 1232 (explaining that a defendant was "obliged clearly to demonstrate" that the price change was due to "intervening events") (quoted in *Nacchio*, 573 F.3d at 1085); Bromberg, Securities Fraud § 6:337, at 6-897 (opining that "a defendant" can try to "reduce the amount of disgorgement by demonstrating that other factors" accounted for the price change) (quoted in *Nacchio*, 573 F.3d at 1085).

Courts discussing disgorgement (and relied on in the Tenth Circuit's decision) have explained that such burden-shifting is warranted because the risk of uncertainty must fall on the wrongdoer. *See SEC v. Happ*, 392 F.3d 12, 32 (1st Cir. 2004) (the defendant "must bear the risk of uncertainty in calculating the amount of disgorgement"); *SEC v. Patel*, 61 F.3d 137 (2d Cir. 1995) (holding that "we agree with the District of Columbia Circuit that any risk of uncertainty [in calculating disgorgement] should fall on the wrongdoer") (internal citations omitted); *First City Fin. Corp.*, 890 F.2d at 1232 (explaining that the burden shifts to the defendant because "the risk of uncertainty should fall on the wrongdoer").

The Tenth Circuit made clear that a district court is not obligated to separate out *all* unrelated factors. It observed that "it is not possible to *entirely* exclude chance market forces" from the calculation. *Id.* at 1086 n.23 (emphasis in original). It explained that the goal is simply to "minimize" the effects of the other unrelated factors. *Id.* at 1086 n.23 ("we simply seek to minimize the influence" of other factors). This willingness to approximate accords with the Tenth Circuit's recognition that the disgorgement approach "may involve some element of imprecision." *Nacchio*, 573 F.3d at 1077; *see also id.* (observing that U.S.S.G. § 2F1.1 cmt. n.9 states that "[t]he loss need not be determined with precision. The court need only make a reasonable estimate of the loss, given the available information," and also quoting the statement in *United States v. Olis*, 429 F.3d 540, 547 (5th Cir. 2005), that "methods adopted in [criminal] cases are necessarily less exact than the measure of damage applicable in civil securities litigation").

C. The Tenth Circuit did not approve any other deductions.

The Tenth Circuit's disgorgement approach does not provide for any deductions (such as for options fees, taxes, or brokerage fees). As described by the Tenth Circuit, it simply is the difference between the gross proceeds the Defendant actually received and the gross proceeds he would have received if he had sold on a specified later date. 573 F.3d at 1084 n.22. The Government notes that the Defendant's expert has not suggested any such deductions. In case there is any doubt, the Government submits that no deductions may be allowed.

The Tenth Circuit's decision makes clear that the option cost is irrelevant to the gain determination. It notes that the "disgorgement approach ... would not factor into the

sentencing equation the wholly unrelated factor of option exercise-cost differences." *Id.* at 1084 n.22.

Taxes are irrelevant, too. The Tenth Circuit's approach does not provide any deduction for taxes. *See id.* at 1084 n.22 (not suggesting any deduction for taxes). This accords with its recognition that the gain, once calculated using the disgorgement approach, must include the "'total increase in value.'" *Id.* at 1073 (quoting U.S.S.G. § 2F1.2 (2000) cmt., background). This focus on the total amount also accords with the calculations under the "loss" section of the Guidelines. *See* U.S.S.G. § 2F1.1, cmt. 8(a) (2000) (explaining that if a defendant represents that a stock is worth $40,000 and the stock is actually worth $10,000, the loss is "the amount by which the stock is overvalued," and suggesting no further deductions).

Perhaps most importantly, courts using the disgorgement approach routinely reject requests to deduct taxes. *See, e.g., SEC v. Aragon Capital Mgmt., LLC*, ___ F. Supp. 2d ___, 2009 WL 4277244, *12 (S.D.N.Y. Nov. 24, 2009) (refusing to deduct taxes paid from the disgorgement amount, and observing that the defendant had "not cited a single securities case in which such an offset was granted); *accord SEC v. Koenig*, 532 F. Supp. 2d 987, 994 (N.D. Ill. 2007) (refusing to allow deduction for taxes paid); *U.S. SEC v. Svoboda*, 409 F. Supp. 2d 331, 345 (S.D.N.Y. 2006) (same); *SEC v. Credit Bancorp, Ltd.*, 2002 WL 3142602, *3 (S.D.N.Y. Oct. 29, 2002) (same).[2]

[2] Moreover, allowing deductions for taxes can "create unwarranted complexities" because "[t]he amount of taxes that a person pays depends" on a variety of factors, such as other deductions. *Cf. United States v. DeFries*, 129 F.3d 1293, 1314-15 (D.C. Cir. 1997) (refusing to allow deduction for taxes in the forfeiture context).

As to broker fees, it does not appear they should be deducted, but it likely does not matter. The Tenth Circuit's straight-subtraction approach does not appear to provide for deduction of brokerage fees. 573 F.3d at 1085 n.22. In any event, the brokerage fees associated with the April and May trades amount to approximately $60,000, and thus are very unlikely to affect the guidelines range in any significant way.

IV. THE DISGORGEMENT APPROACH SHOWS A GAIN OF MORE THAN $50 MILLION.

Applying the disgorgement approach presumptively shows that the Defendant's gain from the offense was greater than $50 million.

A. Applying the Tenth Circuit's approach shows a presumptive $50 million gain as to the convicted counts.

The Tenth Circuit's disgorgement approach is straightforward. Applying this approach to the counts of conviction yields a disgorgement amount of $50,305,145.47.

The calculation is as follows. The Defendant sold 1,330,000 shares, on different days, for gross proceeds of $52,007,545.47. *See* Ex. 1 (stock proceeds chart). As discussed in more detail below, the Government's expert has identified July 31, 2002 as the date when the inside information at issue was absorbed into the market. *See* Ex. 2 (Thakor Report) at 10.[3] On that date, Qwest's stock price closed at $1.28 per share. *See* Ex. 3 (stock price chart). Accordingly, if the Defendant had sold his shares on that date, he would have received $1,702,400 (*i.e.*, $1.28 times 1,330,000). The presumptive gain is the difference between these amounts, or $50,305,145.47.

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[3] For citations to all the expert reports, the page number shown on the document has been used whenever there is a discrepancy between a page number on the document and the page number on the pdf version.

B. The $50 million amount understates the Defendant's total gain.

The Government further submits that applying this approach to only the convicted counts understates the proper amount. The Government presented evidence at trial showing that the Defendant sold shares on the basis of material nonpublic information not only in April and May 2001, but also in January and February 2001. Including the proceeds from those sales would lead to a starting amount not of $52 million but of $100,812,582. *See* Docket #1 at 5.

Although the Defendant was acquitted on those counts, those acquittals do not resolve the issue before this Court. A jury acquittal is not a factual finding against the Government for sentencing purposes. *United States v. Watts*, 519 U.S. 148, 155 (1997) (explaining that an acquittal is not a finding of any fact at all). At sentencing, a court must determine which facts have been established by the applicable, lower standard — the preponderance of the evidence. *See* U.S.S.G. § 6A1.3 cmt. (observing that a preponderance of evidence standard is appropriate at sentencing); *Watts*, 519 U.S. at 155 (holding that where conduct has been established by a preponderance of the evidence, a sentencing court may rely on it even if the jury acquitted as to that conduct).

Under the sentencing scheme prescribed by Congress, a sentencing court is required to focus on real conduct and to eliminate disparities based on its findings. In *United States v. Booker*, 543 U.S. 220 (2005), the Supreme Court explained that Congress adopted the guidelines to establish "similar relationships between sentences and real conduct," and that requiring factual findings at sentencing to be supported by a jury verdict "would destroy the system" by "weaken[ing] the tie between a sentence and an offender's real conduct." *Id.* at 253-55. In other words, the lower preponderance-of-the-

evidence standard gives a sentencing court the ability to make proper distinctions between (a) offenders for whom the evidence shows, by a preponderance of the evidence, other bad conduct and (b) offenders for whom there is no such evidence of other bad conduct.

Here, the Government established the counts relating to the January and February 2001 trades by a preponderance of the evidence. The most significant difference between the acquitted counts and the convicted counts was one of timing: the acquitted counts related to trades in January and February 2001, whereas the convicted counts related to trades in April and May 2001. The Government submits that it established those counts by the lower preponderance-of-the-evidence standard. The Government refers the Court to the evidence discussed in its response to the Defendant's motion for new trial. *See* Docket #561 (Response by United States to Defendant Nacchio's Motion for New Trial) at 9-17 (detailing the material information the Defendant had by early 2001).

If the Court included those additional trades in the gain calculation, the disgorgement amount would be $99,110,182 ($100,812,582 minus $1,702,400). This amount shows that excluding those trades would reduce the Defendant's gain by half. Given the strong evidence that those other trades were in violation of law, the Court should consider this $100 million in calculating gain, and in the sentencing calculus overall. Moreover, the Court should be careful not to treat the Defendant the same as it would treat some other offender for whom there was no evidence of any other improper gain.

V. IF THE COURT RELIES ON AN EVENT STUDY, IT SHOULD FIND THAT THE GAIN EXCEEDS $32 MILLION.

The Tenth Circuit noted that at the original sentencing, the Defendant had submitted a report of an "event study." 573 F.3d at 1068. An event study is a method by which an expert seeks to assess whether a particular event caused an immediate movement in a company's stock price. The expert determines an event date, measure any movement in the stock price over some period of time (perhaps a day or two), and then seeks to eliminate any portions of the movement that appear to be attributable to unrelated market or industry movements.

As set forth below, it is not clear that an event study comports with the Tenth Circuit's approach. But assuming that the Court decides to rely on an event study, the Government submits that a properly conducted event study shows that the Defendant's gain exceeds $32 million. Both the Government and the Defendant have submitted event studies. The main difference in results stems from a difference in the selection of the dates on which the information was disclosed to the market. Because the dates identified by the Government's expert were more rigorously and accurately identified, the Court should rely on results reached by the Government's expert.

A. An event study will understate gain and shift the burden.

The Tenth Circuit did not expressly approve the use of an event study for calculating gain. The court stated that it would "leave it to the district court in the first instance to determine the extent to which such an analysis comports with the disgorgement approach adopted here ...." *Id.* at 1080 n.15.

An event study analysis is somewhat inconsistent with the Tenth Circuit's disgorgement approach. Under the disgorgement approach, the Government can satisfy its burden by showing the price decline before all of the information at issue was disclosed and fully absorbed. The Defendant then has the burden to identify extraneous factors, and to show their effects.

In contrast, an event study shifts this burden. It assumes that all unidentified events outside the event window are unrelated. It also assumes that all price changes outside the event window are attributable to other factors. An event study thus shifts the burden of uncertainty to the Government.

In addition, as discussed in more detail below, the conditions for an event study are not ideal here. First, the information here was not a discrete event. it involved the quality, reliability, and makeup of Qwest's revenue. This information was not released to the market clearly and at once. Instead, the Defendant trickled the information into the market in small bits, over an extended period time. In such situations, an event study may understate the significance of the information.

In sum, there are good reasons for the Court to decline to rely on an event study. The Government recognizes that the Court may wish to consider an event study, and that the Defendant has already prepared an event study. If the Court does rely on an event study, however, it should recognize that such a study almost certainly understates the gain. And to remain consistent with the spirit of the disgorgement approach, the Court should place the burden on the Defendant to resolve any disputed factual issues.

B. A properly conducted event study shows gain exceeding $32 million.

Despite these limitations regarding event studies, the Government is tendering the report of an expert who conducted such a study. The Government is tendering an event study that is more rigorous and complete than the one completed by the Defendant's expert. If the Court elects to rely on an event study, the Government submits that the Court should rely on the report of the Government's expert.

1. Professor Thakor conducted an event study following the accepted economic approach.

The Government's expert is Anjan Thakor, who is the John E. Simon Professor of Finance at the Olin School of Business at Washington University in St. Louis, Missouri. Professor Thakor's report is attached. *See* Ex. 2 (Thakor Report).

Professor Thakor explains that an event study has several recognized steps. First, one identifies the dates and times when the information at issue was disclosed. Second, one determines an event window, which may be the date the information was released (a one-day window) or may include the next day (a two-day window). Third, one measures the stock price change during the event window. Fourth, one identifies the broader market or industry movements on the days in question, and seeks to eliminate the effect of those broader movements. Fifth, the resulting return is examined to determine if it is statistically significant. Finally, one determines the total effect of all the disclosure events. *See id.* at 3 ¶ 13.

Here, Professor Thakor started by identifying disclosures relating to the material nonpublic information at issue. Professor Thakor examined the indictment. Ex. 2 at 2 ¶ 8. He then reviewed extensive materials. He explains, "To identify the events

associated with such disclosures, I have conducted an extensive analysis of news articles, financial filings and analyst reports...." Ex. 2 at 7 ¶ 26. His report lists the materials that were considered. Ex. 2 at 27-68.

In reviewing these materials, Professor Thakor sought to identify disclosures of information that was "withheld at the time of Mr. Nacchio's illegal stock sales" and that was "specifically pertaining to the levels of recurring and nonrecurring revenues, and their implications for the company's future revenue growth." Ex. 2 at 7 ¶ 26. He focused on "the clarity investors had about Qwest's recurring revenues, the part of its revenues derived from one-time transactions, and the impact of the various information disclosures on investors' perceptions of the gap between Qwest's publicly-stated financial targets and recurring revenues." *Id.*

Professor Thakor identified eight disclosure events, on eight dates. He explains that based on his review, he "identified these as relevant event dates because they represent various points in time at which information pertaining to the level of Qwest's recurring and non-recurring revenues trickled into the market and had the potential effect of gradually undoing the earlier obfuscation in Qwest's reporting and Mr. Nacchio's public statements." *Id.* at 10 ¶ 27. He explains in his report that the lack of disclosure persisted for an extended period of time. *Id.* at 10-11 ¶¶ 27-31.

He next "conducted an extensive search of news announcements" around the relevant dates "to verify that there were no other contemporaneous events unrelated to the disclosure of the non-public information in question that might contaminate the effect produced by the disclosure of the relevant non-public information." *Id.* at 11 ¶ 32.

He then analyzed Qwest's stock price movements on the disclosure dates. He used a model to control for both broad market influences and industry influences. Specifically, he measured the historical relationship (1) between Qwest's daily returns and the broad market (represented by the New York Stock Exchange Composite Index), and (2) between Qwest's daily returns and its industry (represented by the American Stock Exchange North American Telecommunication Index). *Id.* at 11 ¶ 33. He assessed the stock price reactions on both the day of the disclosure, and also on the next day. *Id.* at 11 ¶ 33. He also sought to address the influence of any confounding information on those dates. *Id.* at 13 ¶ 35.

Professor Thakor discusses his results with respect to each date. *Id.* at 12 ¶ 34. His results are also set forth in a table. *Id.* at 69. He concludes that cumulative abnormal returns associated with the disclosures are -45.12% (for a one-day event window) and -63.30% (for a two-day window). He concludes with his estimates of gain, which are $23.5 million for the one-day window and $32.9 million for the two-day window. *Id.*

Professor Thakor observes, however, that these numbers may be an underestimate. He observes that "[o]ne important condition for properly capturing the information content of events using the event-study methodology is that event studies look at announcement effects over short-term horizons, which requires sharply-defined events." Thakor Report at 4 ¶ 17. He observes that "in this case, information trickled into the market in small bits over time ...." *Id.* Because the disclosures were spread out over time, this spreading "may have tended to diffuse the effect of specific disclosures." *Id.* at 4 ¶ 17. He explains that "[i]n such situations, the price reactions to specific disclosures

tend to be smaller," and further that "even the statistical significance of the [returns] associated with identifiable events may be biased downward in such cases." *Id.* at 4 ¶ 17.

2. Professor Fischel conducted a study that identifies fewer dates and finds a far smaller gain amount.

The Defendant has also presented an event study. The Defendant's expert is Professor Daniel Fischel, who is the President of Lexecon, a consulting firm, and who is a Professor of Law and Business at Northwestern University. Professor Fischel presented an event study prior to the original sentencing in this case. He now presents a corrected event study. *See* Ex. 4 (Fischel event study).[4]

Professor Fischel identifies five disclosure dates. Ex. 4 at 3-4 ¶ 7, 8 ¶ 13. He examines them against a NASDAQ market index, the CRSP Value-Weighted NASDAQ market index return. Id. at 5-6 ¶ 10. Using this methodology, he concludes that two disclosures produced statistically significant price reactions. *Id.* at 8 ¶ 13. One date (August 22, 2001) showed a negative reaction over the following two trading days (a 12.35% decline); another date (September 10, 2001) actually showed a positive reaction over the next two trading days (a 10.07% increase). *Id.* at 8 ¶ 13.d, 13.e. Professor Fischel decided to compound these two differing results, which yields a overall decline of 3.52%. *Id.* at 9 ¶ 14 & n.19.

Professor Fischel then applies this percentage to the Defendant's gross proceeds from the trades on which he was convicted (i.e., $52,007,549). *Id.* at 9 ¶ 14. He

[4] Professor Fischel presented this event study as a lengthy exhibit to another report. For each of reference, that exhibit has been extracted from the other report, and is included here as a separate exhibit.

concludes that the amount of the Defendant's proceeds attributable to inside information is no more than 3.52% of $52,007,549, or $1,832,561. *Id.* at 9 ¶ 14.

3. The main difference between the event studies is the dates.

The approaches taken by Professor Thakor and Professor Fischel in their event studies are similar in most ways. Both selected disclosure dates, selected comparison indices, analyzed stock price reactions, and calculated a total effect.

One difference is the comparison index selected. Professor Thakor's event study used two indices: both a broad market index (the New York Stock Exchange Composite Index) and an industry index (the American Stock Exchange North American Telecommunication Index). Ex. 5 (Thakor rebuttal report) at 4 ¶ 7. In contrast, Professor Fischel's event study only uses a broad market index, the NASDAQ Composite Index. The Government submits that Professor Thakor's approach is superior. Professor Fischel does not explain why he failed to use an industry index. But as Professor Thakor observes, this difference in comparison indices accounts "for only a small portion of the difference" in the findings. Ex. 5 at 4 ¶ 7.

The main difference between the results stems from the different dates analyzed. Of the eight dates selected by Professor Thakor and the five dates selected by Professor Fischel, only three overlap. Both experts appear to agree that this date difference is the most important difference between the two studies. *See* Ex. 6 (Fischel rebuttal report) at 3 ¶ 6; Ex. 5 (Thakor rebuttal report) at 2-3 ¶¶ 4-5. Accordingly, resolution of the date discrepancy will resolve virtually all of the discrepancy between the conclusions.

C. The Court should find that Professor Thakor properly identified the relevant dates.

The Court should rely on the dates identified by Professor Thakor. First, Professor Thakor's process of identifying the dates was more rigorous and logical than that used by Professor Fischel. Second, the dates identified by Professor Thakor properly relate to the material nonpublic information at issue in the case.

The Government also submits that in selecting dates, the Court should place the burden of proof on the Defendant. As the Government has explained, the presumptive disgorgement amount is $50 million, and it is the defendant's burden to show that the actual amount is less. Given this framework, where there is a disagreement as to a date, the Court should place the burden on the defendant to establish that Professor Thakor should not have included the date in question in his analysis.

1. Professor Thakor used a more appropriate method to identify the significant events.

One reason the Court should use the dates selected by Professor Thakor is that the process by which Professor Thakor selected the dates was a careful and appropriate one. As discussed briefly above (and in more detail in his report), Professor Thakor reviewed the indictment and conducted an extensive review of news articles, financial filings and analyst report. Ex. 2 at 7 ¶ 26; *see also id.* at pp. 27-68.

In contrast, Professor Fischel's approach was less empirical and less complete. He does not represent that his selection of dates was the result of a careful review of all possible events. He does not suggest that he conducted an extensive review of company filings, news reports and analyst reports. Rather, his citations indicate that he relied just on portions of the record of the criminal trial. Ex. 4 (Fischel Corrected Report) at 3 ¶ 7 &

nn.2-8. He offers no explanation for limiting the materials to be used in his study to those materials.

Professor Fischel also appears to have imposed unwarranted date restrictions limits on his review. He states that his analysis focuses on disclosures made by Qwest during the period from May 29, 2001 (the date of Mr. Nacchio's last sale) to September 10, 2001 ...." Ex. 4 (Fischel Corrected Report) at 3 ¶ 7. There is no indication that Professor Fischel even considered any disclosures after September 10, 2001.

This date restriction is unjustified, especially given that Professor Fischel was aware that this date restriction was subject to criticism. Prior to the first sentencing, the Government criticized Professor Fischel's original event study as significantly flawed, particularly in not giving any reasons for limiting the disclosures he analyzed to those ending on September 10, 2001. Docket #452 at 11-16. The Tenth Circuit noted that the Government had criticized Professor's Fischel's original report as flawed. 573 F.3d at 1068 (noting that the Government argued that the "study was flawed"). But even in his Corrected Report, Professor Fischel still provides no explanation of why he did not examine dates after September 10, 2001.

In his rebuttal report, Professor Fischel points to the Tenth Circuit's opinion as a basis for limiting the dates to September 10, 2001. Fischel Rebuttal at 4 ¶ 8. He claims there is "no basis in the Tenth Circuit opinion for Professor Thakor's decisions to include the Additional Disclosures." *Id.* As support, Professor Fischel quotes from the "Background" section of the Tenth Circuit's decision, which described some of the evidence at trial about how the disclosures trickled out. Ex. 6 (Fischel rebuttal report) at 2 ¶ 4 (quoting *Nacchio*, 573 F.3d at 1064).

This purported basis for limiting the dates — *i.e.*, that the Tenth Circuit mentioned them in passing — should be rejected. First, it is apparent that Fischel did not originally select these dates based on the Tenth Circuit's opinion. After all, Fischel selected the same dates in his original report, long before the Tenth Circuit decision.

Second, nothing in the Tenth Circuit's opinion suggests that it making factual findings. Indeed, appellate courts do not make factual findings; they review them. *See Pullman-Standard v. Swint*, 456 U.S. 273, 291 (1982) (observing that "[f]actfinding is the basic responsibility of district courts, rather than appellate courts") (internal quotation marks omitted); *see also Anderson v. City of Bessemer City*, 470 U.S. 564 (1985) ("Duplication of the trial judge's efforts in the court of appeals would very likely contribute only negligibly to the accuracy of fact determination at a huge cost in diversion of judicial resources").

Third, nothing in the Tenth Circuit's opinion suggests that it was requiring the district court to limit its analysis of gain to the facts the Tenth Circuit set forth. This Court has clear authority to consider new facts that are relevant to an issue on which resentencing has been ordered. *See United States v. Gallant*, 537 F.3d 1202 (10th Cir. 2008) (clarifying that a district court may consider evidence beyond the trial record on a resentencing remand, including where the district court confronts "complex factual issues" such as the "calculation of loss"). This Court clearly is aware of this principle, as it has already recognized that determining gain may require "evidentiary presentation." *See* Docket #584 (Order Regarding Resentencing) at 8 (observing that the "gain ... issue[] likely will involve evidentiary presentation"). Accordingly, the Court should reject any

suggestion that the disclosure dates must be limited to those alluded to in the background section of the Tenth Circuit's opinion.

In sum, the method by which Professor Thakor selected the disclosure dates is superior to the method Professor Fischel used. It is based on a more extensive review, it was not limited to data from the criminal trial, and it was not limited to a certain date.

2. Professor Thakor relied on a correct understanding of the information at issue.

Professor Thakor's report explains that his review of disclosure events was narrow. He explains that he sought to identify disclosures of information that was "withheld at the time of Mr. Nacchio's illegal stock sales" and that was "specifically pertaining to the levels of recurring and nonrecurring revenues, and their implications for the company's future revenue growth." Ex. 2 (Thakor report) at 7 ¶ 26. He focused on "the clarity investors had about Qwest's recurring revenues, the part of its revenues derived from one-time transactions, and the impact of the various information disclosures on investors perceptions of the gap between Qwest's publicly-stated financial targets and recurring revenues." *Id.* at 7 ¶ 26; *see also* Ex. 5 (Thakor rebuttal report) at 1 ¶ 3.

By contrast, Professor Fischel took an extremely narrow view of the information at issue. He explains that his understanding was "that the Government alleged at trial that Mr. Nacchio traded on the basis of 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." Ex. 3 (Fischel Corrected Report) at 2 ¶ 5. He explains that he was "asked by counsel for Mr. Nacchio to estimate the portion of Mr. Nacchio's sales

proceeds that can be attributed to inside information concerning these issues...." *Id.* at 2 ¶ 5.

Professor Fischel's extremely narrow understanding of the case cannot withstand scrutiny. As explained in detail below, the case charged by the Government and tried to the jury did *not* focus just on the magnitude of IRU transactions and the ability to reach 2001 targets. Evidence regarding IRUs was presented, but the case also involved information regarding other kinds of nonrecurring revenue and recurring revenue. The case did not focus solely on the amount of the IRU transactions. And while Qwest's ability to achieve its 2001 guidance was part of the case, the nonpublic information also included information regarding Qwest's sources of growth and the sustainability of its growth based on the nature and quality of its revenue.

To address Professor Fischel's overly narrow characterization, the Government will explain how the charges brought in this case, and the evidence presented at trial, show that the material nonpublic information at issue extended far beyond just the size of IRUs and the 2001 targets.

a. The charges related broadly to information relating to the amounts and quality of Qwest's revenue.

The indictment charged Nacchio with selling stock on the basis of several different pieces of material, nonpublic information. *See* Docket #1 (Indictment)) at ¶ 9. The material information it described was not limited to IRUs and 2001 guidance.

The indictment largely focused on the fact that Qwest's business included two types of revenue: (1) "recurring" revenue, which Qwest earned each month during the life of a customer as it rendered services to that customer; and (2) "non-recurring" revenue,

which resulted from one-time transactions. Docket #1 (Indictment) at ¶ 5. These types of revenues largely reflected the two parts of Qwest. In June 2000, Qwest (later known as "Classic Qwest"), a seller of transmission capacity, had merged with US West, a traditional local telephone company.

i. Categories of nonpublic information

These two types of revenue were a central focus of the indictment. The indictment alleged that the material nonpublic information fell into several categories:

(a) *Aggressiveness of targets.* Qwest's targets were "extremely aggressive." Docket #1 at 2-3 ¶ 6(a)).

(b) *Premises of business plan.* Qwest's business plan for meeting its targets depended on a "significant increase" in the growth of its recurring revenue. *Id.* at 3 ¶ 6(b)).

(c) *Past revenue.* In the past, Qwest's "track record" of growing its recurring revenue was poor. *Id.* at 3 ¶ 6(c).

(d) *Actual recurring and nonrecurring results.* The indictment alleged that starting in early 2001, Qwest's recurring revenue was "not growing at a sufficient rate"to meet its targets. *Id.* at 3 ¶ 6(d).

(e) *Quality of recurring and nonrecurring revenue.* The indictment alleged that there were undisclosed risks relating to Qwest's recurring and nonrecurring revenue streams. *Id.* at 3 ¶ 6(e).

(f) *Risky and unsustainable reliance on nonrecurring revenue.* In 2001, Qwest increased its reliance on one-time transactions, and that these transactions were "risky and unsustainable." *Id.* at 3 ¶ 6(f).

(g) *Falling demand for nonrecurring revenue.* There were "insufficient non-recurring revenue sources" to allow Qwest to reach its targets. *Id.* at 3 ¶ 6(g)

ii. Information about nonrecurring revenue

In two bills of particulars, the Government further explained that there were several pieces of material nonpublic information relating to nonrecurring revenue.

The bills did not suggest that nonrecurring revenue consisted just of IRUs. Rather, they explained that there were two categories of nonrecurring revenue: (1) sales of capacity (often structured as IRUs) and (2) sales of equipment. The Government explained that "Non-recurring revenue consisted almost entirely of IRU and equipment sale revenue," and that "The risky and unsustainable one-time transactions were primarily capacity sales known as IRUs (indefeasible rights of use) and equipment sales." Docket #41 at 12.

Another material piece of information was that Qwest's nonrecurring revenue included "swaps," which involved not just a sale by Qwest but also a simultaneous purchase from other party. Docket #155 at 2. Such sales were subject to greater scrutiny by investors, and made revenue recognition harder. *Id.* at 2.

The bills also highlighted the way that Qwest was recognizing revenue from these sales – *i.e.*, when the transaction was entered into. Docket #155 at 3 (noting the "pressure to maximize up-front revenue recognition").

The bills also noted that Qwest had information that nonrecurring revenue was risky, less predictable, and less sustainable. It was not as "insulated" as other revenues from a "lagging economy" or from fluctuations in demand. *Id.* at 2-3. The Government

also noted Qwest's expectation in 2001 that such "non-recurring revenue would decline precipitously." *Id.* at 5.

iii. Past, current and projected numbers

The bills made clear that the nonpublic information at issue included Qwest's past, present, and projected results. They explained that the nonpublic information included "non-public historic information" as well as "internal assessments of Qwest's business prospects" and actual operating results beginning in January 2001. Docket #41 at 5. They further explained that the material information at issue included the facts that Qwest had relied on nonrecurring revenue sources (in the past) to offset shortfalls in increase in recurring revenue, that investors sought more information into the makeup of Qwest's revenue numbers, and that in 2001 Qwest anticipated nonrecurring revenue to experience a significant decline. Docket #155 at 2, 5.

The bills made clear that the targets at issue included not just projections for 2001, but projections for 2002 as well. The Government explained that Qwest knew that its 2001 results would affect its targets for later years (2002 and beyond) because "by missing 2001's targets, future targets would be jeopardized." *Id.* at 1.

b. The evidence at trial included several types of nonpublic information regarding the amount and quality of Qwest's revenue.

Like the indictment, the evidence at trial showed that the material nonpublic information at issue was not limited to just IRUs, and was not limited to just whether Qwest would make a particular target. Rather, the evidence showed that the material nonpublic information related to the breakdown and quality of Qwest's revenues more generally. It included information on not just IRUs, but equipment sales and swaps. And

it included not just information about Qwest's revenues and earnings from early 2001, but also information it had about its past and projected revenues.

The evidence of the entire trial will not be presented here. This summary is presented only to address Professor Fischel's overly narrow characterization of the information at issue.

i. Information about Qwest's revenue

The evidence at trial showed that in 2000 and 2001, Qwest still had significant non-recurring revenue. This revenue typically resulted from one-time transactions, such as equipment sales or extremely long-term (often 20-year) leases of transmission capacity called "IRUs" (indefeasible rights of use). Because Qwest booked the revenue from an IRU sale all at once, and because Qwest had to discover new IRUs every quarter, it was "axiomatic" that IRUs were less reliable income than "recurring revenue" — *i.e.*, income earned monthly from regular subscribers. *See* Ex. 7 (Casey testimony) at App. 2459-2460, 2463, 2466.

Nacchio knew that the nonrecurring revenue was lower quality. He viewed IRUs a an "accounting trick[]" that Qwest used to "make [its] numbers" when recurring revenue fell short, and that recurring revenue was "more valuable" than IRUs "in terms of what the marketplace valued in Qwest." *See* Ex. 5 (Casey) at App. 2461, 2464-2466; *see also* Ex. 8 (Wolfe) at App. 1574 (Nacchio knew these "one-timers" were a "problem").

In addition to IRUs, Qwest's nonrecurring revenue included equipment sales. Ex. 8 (Wolfe) at 419-22); Ex. 9 (Szeliga) at 788). The equipment sales were "large and big," and Qwest used them to "come in and backfill" its revenue. Ex. 9 (Szeliga) at 793). The "last deals to come in in the quarter that pushed the number over the target were ... in

some instances equipment sales." Ex. 9 (Szeliga) at 1044). For equipment sales, like IRUs, the revenue was received up front. Ex. 10 (Mohebbi) at 1780). But also like IRUs, selling equipment had little predictability: "every quarter you'd have to start all over again." Ex. 7 (Casey) at 1076). Equipment transactions thus were referred to as "one-timers" and "represented higher risk" for the sustainability of revenues. Ex. 11 (Graham) at 1221.

ii. Information about Qwest's growth

Qwest's growth rates were significant to investors. There was ample evidence at trial that Qwest's value was highly tied to its impressive revenue growth rate. In July 2000, after Qwest had just completed a merger with US West, Nacchio told employees that the newly-formed Qwest would "grow or die." GX 514A (video exhibit).[5] Nacchio repeatedly stated that Qwest's growth was "very important" because Qwest held itself out "as a growth company." Ex. 9 (Szeliga) at App. 2109. He explained that Qwest's stock price would suffer if it did not meet its high revenue, earnings, and growth targets. GX 506A (video exhibit); *see* Ex. 9 (Szeliga) at App. 2117-2122. He spoke "on several occasions" about how Qwest was "a growth company." *Id.* at App. 2117. Qwest's head of investor relations agreed that Qwest's stock price was affected by the fact that it was known as a fast growth company. Ex. 8 (Wolfe) at App. 1561-62, 1567-68. He explained that if investors "anticipated the earnings results were not sustainable," investors "would sell the stock and/or not buy it." Ex. 8 (Wolfe) at App. 1632-33. In short, Qwest's ability to maintain its growth was highly important to how investors valued Qwest stock.

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[5] GX 514A is a video exhibit. The Government believes the Court already has this exhibit. If it does not, one will be delivered, as it cannot be e-filed.

On September 7, 2000, Nacchio issued a public announcement telling investors that Qwest was raising its targets, including its growth rates. When Nacchio made this announcement, he failed to mention that Qwest had not yet even built an overall budget plan for 2001. *See* Ex. 9 (Szeliga) at App. 2137-2138; Ex. 7 (Casey) at App. 2716.

In late 2000, Nacchio learned additional adverse information about Qwest's ability to meets these newly raised growth targets. He learned that Qwest's 2001 budget required it to make a highly dramatic increase in its growth rate for recurring revenue, as opposed to "nonrecurring" or "one-time" revenue. In fact, Qwest would need to *double* the growth rate it had in 2000 for recurring revenue. *See* Ex. 9 (Szeliga) at App. 2203; Ex. 11 (Graham) at 2599-2600. Nacchio knew this shift was "unnatural" and probably not "achievable" (Ex. 11 at App. 2604), because Qwest had a poor "track record" in growing recurring revenue (Ex. 12 (Mohebbi memorandum) at App. 4990).

Nacchio also learned that this shift would have to happen "right out of the gates" in 2001. Ex. 9 (Szeliga) at App. 2176-2179. Qwest needed new subscribers early in the year so it could count on and build upon their revenue; if it failed to sign up enough new customers early in the year, it would not later benefit from sufficient "compounding" to reach the public target. *Id.* at App. 2179; *see* Ex. 10 (Mohebbi) at App. 3166 ("[I]f somebody at home subscribes to a telephone service that costs $1 a month, if you sell it in January, you're going to collect $12 because they paid 12 times. If you sell that same product in December, you collect $1."). Qwest's budget for 2001 relied on this compounding effect — which applied only for recurring revenues — to generate "a ramp-up in revenues for [the] third and fourth quarter[s]" of 2001. Ex. 10 (Mohebbi) at App. 3200. To grow fast enough to meet the public targets, Qwest would need to make an

"aggressive pivot," or "shift," from one-timers to recurring revenue streams. Ex. 9 (Szeliga) at App. 2177; Ex. 11 (Graham) at App. 2600, 2625.

As Nacchio understood, it was critical for Qwest to make a "pivot" from one-time revenue to recurring revenue. Ex. 11 (Graham) at App. 2601. Nacchio knew that a slow start in obtaining new recurring revenue would have "a snowball effect," dooming Qwest's targets later in the year. Ex. 7 (Casey) at App. 2493-2494. At a 2001 kick-off event, he explained to Qwest's sales staff that "something big" had to happen "by April." GX 559B (video exhibit); *see also* GX 551A (video exhibit) (Nacchio said the first half of 2001 would be "absolutely critical" and "[s]liding into home in December ... is probably not the way you can make this year's numbers").

iii. Nacchio's refusal to disclose this information

Analysts and investors persistently questioned Nacchio and Lee Wolfe (the head of Qwest's investor relations group) about how Qwest could still meet its extremely aggressive growth targets, and about the makeup of Qwest's revenue. Ex. 8 (Wolfe) at App. 1557-1558, 1585, 1599-1620. Wolfe told Nacchio — repeatedly — that investors wanted to know how Qwest made its numbers, and also how much nonrecurring revenue Qwest had. *Id.* at App. 1558, 1576. Nacchio was told that investors wanted to understand how Qwest was going to achieve its financial targets, and that investors wanted to know more about Qwest's revenue, EBIDTA [earnings before interest, depreciation, taxes and amortization], and one-time transactions. *Id.* at App. 1514, 1567-68, 1600. Investors raised the issue that "other telecom companies were reducing their guidance" (*id.* at App. 1613) but that Qwest, in contrast, had not reduced its numbers and

that Nacchio was still "confirming that ... Qwest would make their business plan." Ex. 9 (Szeliga) at App. 2250.

Nacchio chose not to disclose. He exercised close control and "final say" over everything Qwest told the public (Ex. 8 (Wolfe) at App. 1533-1537, 1536), and refused the calls for disclosure. *Id.* at App. 1574-75, 1600, 1605-06, 1611-12. Going a step further, he directed Wolfe to tell Qwest executives that, when speaking with investors, they could not "engage in any conversations about the use of the one-time transactions." *Id.* at App. 1829-1830. Wolfe did as he was told. *Id.* at App. 1830; Ex. 7 (Casey) at 2468. Nacchio would address questions, but Wolfe noted that Nacchio failed to fully disclose that Qwest was relying on one-timers to make its numbers. Ex. 8 (Wolfe) at App. 1613, 1618.

As 2001 progressed, investors' questions about Qwest's ability to make its public guidance and about the makeup of its revenue became urgent. By April 2001, investors were growing "increasingly frustrated" because Qwest had still given them no "visibility" into the "black box" of revenue and growth. Ex. 8 (Wolfe) at App. 1592, 1615, 1618. As Wolfe and Nacchio regularly discussed, the investors' questions became more "accusatory in terms of ... 'what are you guys doing that enables you to continue to meet the numbers.'" *Id.* at App. 1618-1619.

Several of Nacchio's top corporate officers stated that Nacchio should provide greater disclosure to investors about the composition and quality of Qwest's earnings and revenue. Lee Wolfe, the head of investor relations, told Nacchio "three or four times" that he should disclose the information because investors needed it to determine whether Qwest would "be able to continue to grow" and because it would enable them "to make

an informed decision whether to buy or sell the stock." *Id.* at App. 1632-1633, 1655, 1799. After some early 2001 numbers were known internally, Afshin Mohebbi, the president of worldwide operations, gave Nacchio a memorandum stating that the market was "now demanding more visibility in terms of our revenues," and Mohebbi recommended that Nacchio break down the data further. Ex. 12 at App. 3214. In response to the memorandum, Nacchio confronted Mohebbi and demanded, "why are you writing this? ... It's not your job." Ex. 10 (Mohebbi) at App. 3216.

Nacchio responded with disdain to requests that he disclose more to investors. When Wolfe told him that investors wanted greater disclosure, "[a] couple of other times he [the defendant] would say, you know, why do they need to know? And I would say, to make an informed decision whether to buy or sell the stock. And basically, he responded, screw them, go tell them to buy." Ex. 8 (Wolfe) at App. 1798-99.

Nacchio made clear that his reason for not disclosing more about Qwest's revenue was that such disclosure would drive down the stock price. When the defendant was urged by Mr. Wolfe to provide greater disclosure, he repeatedly responded by asking, "[C]an you guarantee me the stock price won't go down," and Mr. Wolfe told him each time that the stock price would go down if he disclosed. Ex. 8 (Wolfe) at App. 1655.

iv. Information about Qwest's recurring and nonrecurring revenue results in early 2001

In early April 2001, Nacchio learned that the results from the first quarter of 2001 (January through March) showed major problems for Qwest's business plan, especially for later in 2001.

As to the global business unit, Nacchio was told that the unit had made its target for that quarter, but was "way off target" in its projected recurring revenue results for 2001. Ex. 11 (Graham) at App. 2630, 2635. Nacchio expressed concern about the recurring revenue results. *Id.* at App. 2635. Nacchio was specifically told that there was $300 million in recurring revenue in this unit that was "absolutely not going to happen." Ex. 11 (Graham) at App. 2649-50. Similarly, during the review of the consumer and small business unit, Nacchio was told that the unit was going to miss its 2001 revenue target by about a third of a billion dollars — $323 million. Ex. 9 (Szeliga) at App. 2234; Ex. 13 (Smith) at 2895, 2900. And the head of Qwest's wholesale unit, Greg Casey, told Nacchio that his unit showed a gap projected of $675 million. Ex. 9 (Szeliga) at App. 2228; Ex. 7 (Casey) at 2499. This miss was to be concentrated "in the second half of the year." Ex. 7 (Casey) at App. 2499.

Nacchio was also presented with an overall product review update in early April 2001, showing recurring revenue results from the first three months of 2001. Ex. 9 (Szeliga) at App. 2200. The update showed, in large font, that as to recurring revenue growth, Qwest faced a "shortfall of recurring revenue growth of 19 percent." *Id.* at App. 2212-13; Ex. 10 (Mohebbi) at App. 3257. The review highlighted for Nacchio several significant shortfalls in certain key recurring-revenue areas where growth early in 2001 had been essential." Ex. 9 (Szeliga) at App. 2210. Nacchio's reaction was clear: he was "not happy" and was "visibly disappointed" with the report. Ex. 10 (Mohebbi) at App. 3260.

v. Information about a coming drop in IRU demand

Nacchio learned another important fact in April 2001: that Qwest was "draining the pond" on IRUs. Ex. 7 (Casey) at App. 2496-97, 2545. Casey told Nacchio that Qwest's IRUs were "going away." *Id.* at App. 2509. Casey explained that while his prior warnings to Nacchio in the fall of 2000 had been about the "difficulty" in the 2001 plans, his April 2001 meeting with Nacchio was different because in that meeting, Casey was made clear that "There was nothing there. It was qualitatively and quantitatively different from what I had said in the past ...." *Id.* at App. 2581. He explained that he had never given Nacchio a warning like that before. *Id.*.

vi. Information about increasing reliance on swaps

In addition, many of Qwest's IRUs in early 2001 involved "swaps," or trades of assets with other companies, of which accountants took "a very dim view." Ex. 7 (Casey) at App. 2495. In a swap, Qwest would buy capacity from another carrier, and the other carrier would buy capacity as well, and each company would send money to the other. Ex. 7 (Casey) at 1192. As it was explained at trial, two companies might agree: if "you're not able to meet ... your revenue numbers, we're not able to meet ours, why don't you buy a million dollars of up-front revenue from us, we'll turn around and buy a million dollars of revenue [from] you, we both get revenues ... a bogus swap kind of revenue." Ex. 14 (Khemka) at 2285.

Most IRUs of any substance in 2001 were being done through swaps. Ex. 7 (Casey) at 1107-08, 1124. Moreover, "the swap market itself for IRUs was finite," and so "[w]e were going to come to an end to it." *Id.* at 1108.

c. The disclosure events selected by Professor Thakor reasonably relate to the information at issue.

The charges and the evidence at trial support the disclosure events identified by Professor Thakor. The charges and the evidence identified a broad range of material nonpublic information. This information was not limited, as Professor Fischel assumes, just to IRUs and Qwest's 2001 guidance. Rather, it included a range of information about the composition, amount, quality, and sustainability of Qwest's revenues and growth.

Professor Thakor's dates are properly tied to that information. This can be seen from a review of the events at issue. Below, the Government reviews each of the different disclosure events identified by Professor Thakor and Professor Fischel. As noted earlier, Professor Thakor identifies eight disclosures events, and Professor Fischel identifies five. Because three overlap, there are ten events overall. For each date, the Government describes the event, and then explains, with references to the professors' reports, whether the date should be included or not.

i. June 20, 2001: Morgan Stanley raises questions about Qwest's future revenue.

The first event identified by either expert is June 20, 2001. On that date, Morgan Stanley Dean Witter (MSDW") issued a report that indicated that it had information raising concerns about Qwest's revenue and earnings. Ex. 15 (MSDW report). The report analyzed a Qwest writedown of assets, and found that it raised serious questions about Qwest's "past and future earnings power." *Id.* at 2. In the writedown, Qwest reduced its assessment of the value of Classic Qwest, which raised "the question of the true earning power of the old Qwest assets." *Id.* at 4. MSDW raised concerns about Classic Qwest's "earnings visibility" and about its "quality of earnings." *Id.* at 5. By

"quality," MSDW explained that it was referring to the "sustainability" of Classic Qwest's revenue, including nonrecurring revenue. *Id.*

This disclosure related to the sustainability of Classic Qwest's revenues. As MSDW later explained, "From the outset our concern was what the accounting was telling us about the sustainability of revenue and operating income." Ex. 16 (8-22-01 MSDW report) at 3. MSDW explained that it did not see "how this write down is consistent with Qwest generating significantly higher revenue from sales of capacity IRUs." *Id.*

Although the June 2001 MSDW report observed that the writedown raised revenue concerns, the report did not discern clear answers. It simply noted that Qwest's writedown raised the issue of "disclosure" and that the writedown of Classic Qwest's assets "makes future visibility more opaque." *Id.* at 5. MSDW chose to cut forecasts of Qwest's long-term revenue "to reflect a lack of visibility." *Id.* at 2.

Professor Thakor included this date in his analysis. Ex. 2 (Thakor report) at 8. Professor Fischel did not. Professor Fischel contends that the report does not mention IRUs or Qwest's 2001 revenue guidance or disclose any information regarding those issues, but simply involves accounting decisions. Ex. 6 (Fischel rebuttal report) at 6 ¶ 10.

The Court should reject the Defendant's argument that this date should be excluded from the event study. It is true that the concerns in the report came to light via an accounting action, a writedown. From that writedown, however, MSDW discerned serious questions about the "sustainability of Qwest revenue growth." Ex. 2 (Thakor report) at 8. As MSDW later explained, the write down was not "consistent with Qwest generating significantly higher revenue from sales of capacity IRUs." Ex. 16 (8-22-01

MSDW report) at 3. As Professor Thakor appropriately recognizes, the report was simply "the beginning of a series of disclosures that revealed to the market previously undisclosed information that was potentially relevant for valuation." Ex. 2 at 8. Professor Thakor finds that the report's effect on Qwest's stock price was not dramatic, but he does find it was statistically significant. Ex. 2 at 69.

ii. July 24, 2001: Nacchio announces results but provides no revenue breakdown.

The next date referred to by either expert is July 24, 2001. On July 24, 2001, during an earnings call about Qwest's second quarter results, Nacchio refused to disclose the breakdown of IRUs and recurring revenue. Ex. 8 (Wolfe) at App. 1652. He confided in Wolfe that he "didn't want to muddy what he felt was ... a good news quarter." *Id.*

Following the July 24 call, investors demanded a revenue breakdown so they could determine the "[q]uality" of Qwest's revenue. Ex. 14 (Khemka excerpts) at App. 3676-3677; Ex. 17 (Khemka memo) at Supp. App. 226. Prashant Khemka, a Goldman Sachs analyst, sent an angry letter to Wolfe and Nacchio telling them there was "a big credibility issue now surrounding Qwest" because of the "opaqueness in ... your revenue breakdown." Ex. 17 (Khemka memo) at Supp. App. 224. Khemka stated that "the lack of transperancy [sic] is going to hurt you because investors don't know how many cockroaches you still have in your bag." *Id.* The "revenue breakdown" to which Khemka referred was how much Qwest was relying on nonrecurring revenue. Ex. 14 (Khemka excerpts) at App. 3677-3680.

Professor Fischel includes this date in his analysis. Ex. 4 (Fischel Corrected Report) at 3 ¶ 7. Professor Thakor does not include it.

The Court should not reject Professor Thakor's decision not to include this date. As discussed, Nacchio refused to disclose any breakdown of Qwest's revenue. In any event, this date is not significant. Professor Fischel did not find any statistically significant price effect from this event. Ex. 4 (Fischel Corrected Report) at 8 ¶ 13.a.

iii. August 7, 2001: Nacchio discloses that Qwest revenue includes nonrecurring capacity sales.

In early August 2001, Nacchio told Wolfe he wanted to release but "spin" the magnitude of IRUs Qwest had done in 2001. Nacchio stated that investors "would not be happy" and "would be surprised at the magnitude of the [IRUs]," and "the stock price would go down." Ex. 8 (Wolfe) at App. 1652-1653.

On August 7, 2001, Nacchio spoke at a conference hosted by US Bancorp Piper Jaffrey. Ex. 18 (8-7-01 Qwest 8K) at 3. In a slideshow presentation (filed that day with the SEC in a Form 8-K), Nacchio assured investors that Qwest had "predictable cash flow and earnings" (*id.* at 5), that he was reaffirming Qwest's guidance (*id.* at 9-10, 14), and that Qwest had "Growth Through Quality Revenues." *Id.* at 6. As part of this presentation, Nacchio disclosed that part of Qwest's revenue included nonrecurring capacity sales. The chart he used did "not give actual ranges or numbers" (*id.* at 8). According to Lee Wolfe, Qwest's head of investor relations, this presentation was "misleading" in some respects, as it omitted part of Qwest's nonrecurring revenue relating to equipment sales. Ex. 8 (Wolfe) at 419-21. The disclosure also included many slides claiming "that Qwest's growth rate significantly exceed that of its peers." Ex. 2 (Thakor report) at 8.

Both Professor Thakor and Professor Fischel include this date in their studies. Ex. 2 (Thakor report) at 8; Ex. 4 (Fischel report) at 8 ¶ 13.b. The Court should find that this date was properly included in both.

iv. August 14, 2001: Qwest discloses amounts of certain nonrecurring sales.

On August 14, 2001, Qwest filed its 10Q quarterly report with the SEC. Ex. 19 (8-14-01 10Q) at 1-2. In the report, Qwest disclosed, for the first time since 1998, its sales of one kind of one-time revenue: its optical capacity under IRU agreements. It disclosed that in the first quarter and second quarter of 2001, it recognized "$430 million and $857 million, respectively, in optical capacity sales under indefeasible right of use ('IRU') agreements versus $197 million and $416 million, respectively, for the comparable periods in 2000." *Id.* at 30.

Both Professor Thakor and Professor Fischel include this date in their studies. Ex. 2 at 8-9; Ex. 4 at 8 ¶ 13.c. The Court should find that this date was properly included.

v. August 22-23, 2001: Analysts raise concerns that Qwest's recurring revenues may be lagging.

Analyst reaction to the 10Q released on August 14 was not immediate. The following week, however, two analyst reports dug into the details of Qwest's 10Q and determined that the reported IRUs actually accounted for a substantial portion of Qwest's recent growth, and that Qwest's inclusion of the IRUs in its revenues had had the effect of inflating Qwest's growth rates of other quality revenue.

On August 22, 2001, Morgan Stanley Dean Witter issued a report finding that the 10Q "provides significant additional information and new details in the area of optical capacity sales under indefeasible rights of use ('IRU') agreements in 2Q01." Ex. 16 (8-

22-01 MSDW report) at 3. Disentangling the numbers, the MSDW report noted that Qwest "generated $430 million from these transactions - some 8.2% of its total revenues and an estimated 25% of classic Qwest revenue. Furthermore, these revenues grew 118% YoY [Year-over-Year] and were a major contributor to growth – accounting for some 41% of total revenue growth. Another way of looking at this shows that excluding IRU agreements Qwest grew its revenues by 7.5% YoY compared to the 12.2% including the IRU revenues." *Id.* at 6.

The report noted that Qwest might have other nonrecurring revenues. Notably, the report noted that it had learned this detail not from Qwest, but from sales to one of Qwest's customers. *Id.* at Part 3 page 1 ("This information is not disclosed from Qwest, but rather was extracted from the customer's own public filings"). MSDW observed that this sale might represent "only a portion of Qwest's equipment sales." *Id.* MSDW explained that these nonrecurring equipment sales were lower quality: these revenues "should be viewed as different, and less valuable, than those generated from the core services business," and "we see no real sustainability or growth in these revenue or profit streams." *Id.* at Part 3 page 2. MSDW observed that this information regarding nonrecurring revenue was significant, because "investors pay significant attention to the price paid relative to the cost and alternative market prices for the same products." *Id.*

MSDW observed that it was still missing key information regarding nonrecurring revenues. It observed that it had "little information on the profitability of IRU and other transactions." *Id.* at 3. MSDW also observed that "Qwest still trades at a premium" compared to its "peer group." *Id.* at 10.

Another analyst report, released the next day, drew similar conclusions from the Qwest 10Q. The report, issued by Davenport and Company (8-23-01 Davenport report), expressed concerns about Qwest's significant revenue from nonrecurring sources: "the company appears to be receiving cash payment from other carriers for long-term fiber optic capacity leases and is recognizing all the revenue up front, rather than amortizing the revenue over the lease term. Ex. 20 at 1. The Davenport report observed that the up-front IRU payments were substantial drivers of Qwest's recent growth. It noted, "in the absence of up-front IRU payments, the company's revenue growth would have been 7.5%." *Id.*

Both Professor Thakor and Professor Fischel include the August 22, 2001 date in their studies. Ex. 2 (Thakor report) at 8-9; Ex. 4 (Fischel report) at 8 ¶ 13.d. The Court should find that this date was properly included.

vi. September 10, 2001: Qwest reduces guidance, but substantially cuts spending.

In August 2001, Nacchio decided to wait before lowering Qwest's public guidance, so he could deceive investors about why the guidance was being lowered. Wolfe overheard Nacchio discussing with Qwest's general counsel the need for a further delay to give investors "the sense that [there] was something *new* that caused the lowering of the targets." Ex. 8 (Wolfe) at App. 1677 (emphasis added). Nacchio said he wanted investors to think that "lowering the targets was something that ... [he] would not have reasonably known" about earlier. *Id.* at App. 1678.

He then issued an announcement on September 10, 2001, Qwest's revenue target down to $20.5 billion — lowering it by approximately $1 billion. Ex. 21 (9-10-01 release) at App. 4933.

Several things are notable about this disclosure. First, the reduction in guidance is one that some analysts had apparently, by this point, guessed. A report issued by MSDW early on the morning of September 11, 2001 showed that the reduction had been expected. "As expected, Qwest lowered its 2001 and 2002 outlook FY01 revs." Ex. 22 (9-11-01 MSDW report) at 1. MSDW noted that Qwest was "pointing to the economy as a culprit." *Id.* at 1.

Second, Nacchio's disclosure was incomplete. At trial, Robin Szeliga (Qwest's CFO) testified that this September 10 disclosure was not full because Nacchio did not mention that Qwest's 2001 plan rested on dramatic growth in recurring revenue that had not occurred. Nor did he mention that the projections were now relying on hoped-for growth in IRU revenues, which Qwest was actually expecting to shrink. Ex. 9 (Szeliga) at App. 2445-46.

Analysts similarly noted that Nacchio's announcement also still did not disclose key information about Qwest's recurring and nonrecurring revenues. MSDW observed that "The guidance provided certainly answered some outstanding questions, but was very limited...." Ex. 22 at 3. MSDW noted, "The composition of IRU versus non-IRU revenues and margins was not provided, nor was there any detailed split of revenues between US WEST and Qwest..." *Id.*

Third, Nacchio's announcement included not just the reduction in guidance, but also other distinct information. Specifically, Qwest announced that it was substantially

reducing its spending on both capital and on employees. *See* Ex. 22 (9-11-01 MSDW report) at 1 ("Also reducing cash burn by lowering capex and cutting headcount.").

Analysts viewed this information as highly *favorable* to Qwest. MSDW noted that "The cuts are severe; we estimate that cash EPS in the second half of 2001 will be some 35% below year ago levels, and 32% below first half levels...." *Id.* at 2. MSDW explained that these cuts favorably addressed prior concerns about Qwest's spending. *Id.* at 2 ("Our concerns on cash burn rates are largely addressed by the 35% cuts in 2002 versus 2001").

Fourth, the MSDW report was issued early in the morning on September 11, 2001. The New York Stock Exchange never opened that day, due to the terrorist attacks. The next trading day was September 17, 2001.

Professor Fischel includes this date. He notes that Qwest's residual two-day return was a positive 9.30 percent, and includes this positive amount in his analysis. Ex. 4 (Fischel Corrected Report) at 8 ¶ 13.e.

Professor Thakor excludes this date from his analysis. He does not, however, contend that this date is unrelated to the information at issue in this case. He explains in detail that including the date would "violate[] an important condition of 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." Ex. 5 (Thakor rebuttal report) at 2-3 ¶ 5. He notes that the positive reaction may indicate that investors were reacting positively to the news about substantial cost-cutting, or that the market expected the reduction in guidance to be even lower. He explains that in either case, there is no reliable way to separate out the positive effect.

In light of Professor Thakor's detailed explanation, the Court should exclude this date. Professor Fischel does not address these concerns at all, let alone explain why a reduction in guidance could be positive information.

Moreover, the Court should not view the reduction in guidance as positive information that offsets other price effects. Professor Fischel uses the positive reaction from this disclosure to offset the negative price reaction he finds on August 22, 2001. *See* Ex. 4 (Fischel Corrected Report) at 9 ¶ 19. Professor Fischel offers no logical basis for this offset. Allowing such an offset would reward Nacchio for having delayed this announcement of adverse information until a time where he also had positive information to announce, and when the market may have already adjusted to the leakage of information that Qwest's guidance might be reduced. *Cf.* S. Buell, *Reforming Punishment of Financial Reporting Fraud*, 28 Cardozo L. Rev. 1611, 1641 (Feb. 2007) (cited in *Nacchio*, 573 F.3d at 1079 & n.14, 1085) (warning that an executive might have a "strong incentive to bury fraud revelations in [a] release of other information," as this would "complicate [the] causation inquiry").

vii. September 29, 2001: A large equipment swap transaction is revealed.

In late September 2001, analysts learned about an equipment sale that gave them significant concerns about the composition of Qwest's revenues. A telecommunications company named Calpoint disclosed that it had negotiated with Qwest a previously-undisclosed series of swap transactions in which Qwest agreed to sell Calpoint approximately $200 million of equipment.

Qwest recognized that this transaction would raise questions more generally regarding its nonrecurring revenues. On September 26, 2001, Lee Wolfe, Qwest's head of investor relations, wrote Nacchio a memorandum in which he observed, "The main issue regarding Calpoint for most investors is what will underlying revenue growth rates be when 'one-time' revenues, including Calpoint equipment sale, are pulled out." Ex. 23 (9-26-01 memorandum).

As Wolfe predicted, analysts raised these precise concerns. The Calpoint transaction was disclosed on September 27, 2001. Ex. 2 (Thakor report) at 9. The next day, September 28, 2001, J.P. Morgan issued a report stating that the Calpoint transaction raised "concerns regarding Qwest's revenue quality." Ex. 24 (9-28-01 J.P. Morgan report) at 10. J.P. Morgan opined that "the real growth rate of Qwest revenue, i.e. excluding non-recurring items, appears to be below its comparables." *Id.* at 1.

The J.P. Morgan report observed that this latest news related to Qwest's revenue quality and revenue growth. It noted that "Qwest has recently faced criticism about the non-recurring nature of many of its bandwidth capacity contracts." *Id.* at 1. It commented, "The steady tide of negative news flow concerning Qwest has continued, raising questions about revenue quality and sustainability, the stability of wholesale customers, and the possibility of management issues. In our opinion, the most serious of these items relates to the quality of Qwest's revenue and the implications for the company's core revenue growth." The J.P. Morgan report took note of "the uncertainty surrounding the quality of Qwest's revenue." *Id.* at 2.

The Calpoint transaction was also cited by other analysts as raising concerns about the amount and quality of Qwest's nonrecurring revenue. On October 1, 2001, Banc of

America Securities issued a report citing the Calpoint transaction, and observing that "this particular transaction has led investors to question the quality of Qwest's going forward revenue and earnings." Ex. 25 at 2. Banc of America noted that Qwest's management had indicated that they were not changing Qwest's most recent (September 10) guidance *Id.* at 3. But Banc of America nevertheless downgraded Qwest's rating, citing the Calpoint transaction, "reduced income statement visibility," some management departures, and "recent events including material revenue and EBITDA revisions (on 9/10/01)." *Id.* at 1, 8.

A week later, on October 8, 2001, ABN-AMRO highlighted the Calpoint transaction in a report, explaining that the transaction meant that "further clarity is needed" from Qwest "on how much of Qwest's revenue and EBITDA is equipment related and not related to the company's core competencies." Ex. 26 (10-8-01 ABN-AMRO report) at 309. ABN-AMRO explained that the value of the Classic Qwest portion of Qwest "depends on the quality of the Classic Qwest revenue and EBITDA stream, a portion of which has recently been subject to debt [sic] and uncertainty. The recent effective sale and leaseback agreement with Calpoint has brought into question how much of Qwest's revenue stream is in fact entirely equipment related and not related to Qwest's core competency. Without access to this information, which we may not receive until the company files its 10-K for 2001, it is simply too early to determine what percentage of our 2002 revenue and EBITDA estimate might be associated with equipment sales and/or effective asset swaps recorded as revenues as happened in 2Q01." *Id.* at 2.

Professor Thakor includes this date in his study. Ex. 2 (Thakor report) at 9. Professor Thakor explains in his report that this equipment sale and swap revealed undisclosed information about Qwest's nonrecurring revenue stream and its unsustainable revenue growth rate. *Id.* Professor Fischel does not include it. He gives two reasons for excluding it: it was after September 10, 2001, and it did not concern IRU sales. Ex. 6 (Fischel rebuttal) at 6-7 ¶ 11.

The Court should reject the Defendant's argument that this date should be excluded. As discussed above, Qwest knew internally that analysts would be surprised by the Calpoint transaction and that it would raise questions about how Qwest was growing its revenues. And analysts did learn for the first time what Qwest knew in early 2001 (when Nacchio was selling his stock): that Qwest's nonrecurring revenues included large equipment sales and swaps. Moreover, this information came as a surprise; the two-day reaction to this disclosure was significant. See Ex. 2 (Thakor report) at 69.

viii. October 31, 2001: Qwest's results show weak demand for capacity sales, but its revenue breakdown remains unclear.

In early October 2001, analysts continued to complain that they were unable to determine how much of Qwest's revenue was nonrecurring and unrelated to its core business. The October 8, 2001 ABN-AMRO report explained that it was "therefore unable to convincingly value the Classic Qwest component of the business." Ex. 26 at 1. It emphasized that the key issue was determining how much of Qwest's revenue was recurring revenue related to traditional subscribers. It explained, "We have attempted to determine what contribution the US West ILEC [Incumbent Local Exchange Carrier – i.e., a local telephone company] business has been making to consolidated Qwest results,

in a broader attempt to decipher how the market should be valuing the two major components of Qwest's business. It is very difficult to extract what EBITDA is for the Classic Qwest and the old US West given the company's reporting structure." *Id.* at 2. ABN-AMRO emphasized that "we do believe there is value associated with the Classic Qwest part of the business. However, we believe it will be difficult to quantify until we understand what portion of the revenue and profit stream is recurring in nature and what portion is merely related to a series of one-time events." *Id.* at 3. It was in this context of continued uncertainty that Qwest released its third-quarter results on October 31, 2001.

On October 31, industry analysts learned something Nacchio had learned back in April 2001 (before he sold his stock): that demand for Qwest's capacity IRUs had dried up. Qwest indicated that its earnings were short due to a decline in the market for its IRU transactions. Ex. 27 (Qwest 8-K); Ex. 2 (Thakor report) at 9. Qwest 8-K. In a report the next day, J.P. Morgan observed that "the most significant impact" on Qwest's third-quarter revenues was "a collapse in demand for lit capacity in the form of sales-type leases." Ex. 28 at 1. It observed that "[t]he 'Classic Qwest' businesses were severely impacted by a fall-off in demand for lit capacity." *Id.* at 2. This drop in capacity indicated that future IRU would decline as well: "We expect margins to contract further next quarter as high margin capacity sales slow dramatically." *Id.* at 1.[6]

The J.P. Morgan report questioned whether Qwest was still entitled to a premium on its stock price based on a fast growth rate. It commented, "Qwest has historically

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[6] Analysts had not previously been informed that demand for Qwest's IRU revenue had dried up. For example, in an August 2001 report, Prudential Securities stated that it expected that "carrier sales, including IRU sales, are sustainable." Ex. 29 at 2. The report expected "strong underlying demand" for these transactions. *Id.*

traded at a premium to its competitors on the basis that it appeared to be growing revenues at a faster rate. It appears now that revenue growth in prior periods was overstated." Ex. 28 at 2. The report explained that Qwest had enjoyed a "higher multiple" due to this revenue growth, but that this multiple was in question. "Furthermore, the higher multiple that was accorded to Qwest on the basis for faster revenue growth was being applied to inflated EBITDA numbers (one-time items had significantly higher EBITDA margins than the recurring revenues)." *Id.*

The third-quarter results also showed that Qwest had heavily relied on IRUs and swaps to reach its growth targets in early 2001. In a report on December 11, 2001, Merrill Lynch noted that the 10Q IRU numbers "highlight the extent to which these IRUs have been crucial to the company achieving its growth targets in prior quarters." Ex. 30 at 3. It observed that the 10Q also disclosed that Qwest had "entered into $870MM worth of swap type equipment transactions with vendors during the nine months ended September 30, 2001." *Id.*

Professor Thakor includes this October 31, 2001 disclosure in his event study. Ex. 2 at 9. As Professor Thakor observes, this disclosure indicated that Qwest's revenues fell short of its targets due to a decline in the market for IRU sales, and that based on information in the report, analysts determined that Qwest's revenue growth in prior periods was overstated. *Id.*

Professor Fischel does not include this date. He contends that this event it should not be included because he says (without explanation) that it provided new information about current market conditions that Mr. Nacchio is not alleged to have had during the period when he was selling stock. Ex. 6 at 6-7 ¶ 11.

The Court should find that this date should be included. As discussed above, the most important information in this disclosure was the collapse in demand for Qwest's capacity, which led to Qwest missing its earnings numbers. Professor Fischel completely ignores the fact that Nacchio knew back in April 2001 that demand for its capacity sales was drying up.

ix. February 13, 2002: The market learns that Qwest had other large nonrecurring-revenue transactions in 2000 and early 2001.

The uncertain nature and quality of Qwest's revenues from 2000 and 2001 persisted into 2002 due to the lack of disclosure from Qwest about its revenue. As J.P. Morgan observed in a November 2001 report to investors, Qwest still had not provided the information analysts needed to model the company's future results. It commented "that no historical results were broken out, therefore, it is more difficult to identify a trend line for modeling future results." Ex. 28 at 2.

Similar frustration about the continuing lack of information from Qwest was expressed by other analysts. In a November 1, 2001 report, ABN-AMRO reported, "We had originally thought that the third quarter report would bring clarity to the differences between the local business (former US West) and the classic Qwest business, which included the former LCI International. Unfortunately, we have left the call more confused than before and are ill equipped to provide investors with an understanding for how the revenues and profits would break down. ...." Ex. 31 at 2. The report explained that Qwest reported some information for the first time, but gave investors no baseline for them to measure growth. "It has become increasingly difficult to track the growth of Qwest's Internet, Data and IP services, which is of some concern .... The difficulty began

anew this quarter as Qwest has for the first time reported the growth of the recurring Internet, Data and IP services, whereas in the past, the company spoke of only growth in total Internet, Data, and IP services revenues, not growth in recurring services revenues. ... [W]e are left guessing from what base recurring revenues grew..." *Id.* at 3. The report explained that the analysts had to return to 1999 numbers to try to guess the growth rate. "[W]e are left to return to the latest reported stand-alone US West report in 1999 to estimate what the 2002 estimate might be." *Id.* at 2.

As ABN-AMRO emphasized, this lack of clarity from Qwest was a continuing pattern: "Once again we find ourselves attempting to value Qwest ... We had hoped to achieve further clarity in the third quarter report, but once again it was very difficult to extract what EBITDA was for the classic Qwest and the old US West given the company's reporting structure." *Id.* ABN-AMRO emphasized that "there is value to the Classic Qwest asset," but "without clarity on the components of Classic Qwest revenue and EBITDA, we cannot fully support such a valuation and therefore cannot recommend these shares at all or without visibility into next year." *Id.* at 2-3.

The December 11, 2001 Merrill Lynch report similarly highlighted that it remained unclear how much Qwest's growth rate was based on recurring revenues. Merrill Lynch noted that questions about Qwest's recurring revenue "have clouded the sense of what Qwest's 'real' growth trajectory is." Ex. 30 at 3. The Merrill Lynch report stressed that "Qwest's reporting of revenues does not make for helpful comparisons with peers nor does it provide a clear view of revenue drivers." *Id.* It thus remained the case that Qwest investors still did not know the quality and makeup of Qwest's revenue.

On February 13, 2002, investors learned more. The Wall Street Journal reported on transactions that gave investors new reason to be concerned about Qwest's revenues from 2000 and 2001. Ex. 32. The Journal reported that in four deals in 2000 and 2001, Qwest had sold a large amount ($450 million) of equipment to another company (KMC Telecom Holdings), had paid KMC for services using the same equipment, and then had included the one-time equipment sale as revenue. *Id.* at 1. The Journal noted that Qwest had not disclosed these equipment-sale transactions in any prior filings, even though three of those transactions dated back to May 2001. *Id.* at 1-2. The Journal quoted an analyst as noting that Qwest's recognition of revenue on these transactions had given "the impression that they're growing at a higher-than-expected rate." *Id.* at 1.

Professor Thakor includes this disclosure in his study. Ex. 2 (Thakor report) at 9-10. Professor Fischel does not.

The Court should find that Professor Thakor properly included this disclosure event. All but one of these KMC transactions occurred before Nacchio's April-May stock sales. The KMC transactions highlighted to investors the large amount of nonrecurring revenue Qwest relied on to meet its revenue targets during that time – a fact that Nacchio knew, and investors did not. As Professor Thakor explains, the transactions shed light on the fact that Qwest had been using equipment sales and swaps in 2000 and 2001 to boost its revenue growth, and that this gave investors the impression that Qwest was enjoying faster-than-expected growth. Ex. 2 at 9-10.

Professor Fischel contends that this disclosure should be excluded because it did not concern IRUs. He apparently takes the position that equipment sales were beyond the

scope of this case. But as noted above, information regarding the nature and extent of Qwest's equipment sales was part of the material nonpublic information in this case.

x. July 29, 2002: Qwest discloses approximate overall amount of IRU revenue from 2000 and 2001.

The overall scale of the revenue Qwest booked in 2000 and 2001 for its nonrecurring-revenue transactions was not fully disclosed by Qwest until mid-2002. On July 29, 2002, Qwest (under a new CEO) announced that it would have to restate its revenue and earnings from 1999 through 2001, primarily regarding its nonrecurring transactions and the revenue for those transactions. Ex. 33 at 2. Qwest explained that it might have to restate all optical capacity sales. *Id.* at 1. The scope was very large: the total optical-capacity sales totaled about $1 billion for 2000 and $486 million for 2001. *Id.* at 2-3.

Professor Thakor includes this announcement in his study. Ex. 2 at 10. Professor Fischel does not.

The Court should find that Professor Thakor properly included this disclosure event. This restatement issue focused on nonrecurring sales, particularly IRU sales, and it brought into question the revenue booked by Qwest in previous years and the sustainability of Qwest's revenues. In particular, it showed that Qwest had aggressively booked its revenue up front for these nonrecurring revenue transactions, a practice that was well within the scope of the charges and the trial. This was information that Nacchio was aware of when he sold but that outsiders were not because Nacchio had refused their calls for disclosure about the quality and source of Qwest's revenues.

Professor Fischel argues that the restatement related to IRU accounting decisions for which Nacchio was not responsible. Ex. 6 at 6-7 ¶ 11. This argument misses the point. The issue was not whether Nacchio was responsible for accounting, but whether he knew the underlying information: that Qwest was relying on a large amount of IRU revenue and that it booked this revenue up front to achieve its growth targets, thus reducing the sustainability and predictability of Qwest's income. Fischel does not contend that Nacchio did not know this underlying information.

In sum, the Court should find that Professor Thakor's selection of dates are appropriate, and that a preponderance of the evidence shows that those events are sufficiently connected to the information at issue in the case. The Court should reject Professor Fischel's date restriction and his unjustifiably narrow view of the information at issue in the case.

3. A separate "buy-and-hold" study confirms that the market was reacting to Qwest-specific information during the relevant period.

A separate study provides further confirmation of the dates selected by Professor Thakor, and his resulting calculation of the Defendant's ill-gotten gains. This separate study indicates that during the period that includes the disclosure dates identified by Professor Thakor, Qwest stock price did not just track the prices of similar firms. Instead, Qwest's stock price was reacting to Qwest-specific information.

The analysis at issue is called a "buy-and-hold" analysis. Professor Thakor examined whether Qwest's stock price, during the period during which the disclosures were made, was being impacted solely by industry declines applicable to firms with characteristics similar to Qwest, or whether Qwest was underperforming those similar

firms. Ex. 2 at 14-15 at ¶¶ 40-44. For this alternative analysis, Professor Thakor created a portfolio of telecommunications firms with characteristics similar to Qwest, and compared Qwest's performance against this portfolio, over the period including the eight disclosures at issue.

This buy-and-hold analysis shows that during that period, Qwest's stock price significantly underperformed its peers. By contrast, the analysis shows that in the three years prior to the analysis period, Qwest did *not* underperform its peers.

This analysis provides further basis for concluding that the "market reacted negatively and significantly to the multiple disclosures of Qwest's IRU transactions and equipment sales, and the negative information this conveyed to investors about Qwest's future revenues." Ex. 2 at 15 ¶ 43. The study confirms that during the period identified by Professor Thakor, Qwest's stock price was reacting to information that investors were learning specifically about Qwest, not just about the industry Qwest was in.

D. Professor Thakor's calculations are an underestimate.

The above recitation of facts also fully supports Professor Thakor's conclusion that "in this case, information trickled into the market in small bits over time." Ex. 2 at 4 ¶ 17. The record, as detailed above, shows that there was a significant delay before all the information was disclosed; that the information at issue was divided into bits and trickled out separately; that the disclosures that were made were persistently incomplete and unclear; and that the disclosures continued to surprise even expert analysts.

Professor Thakor explains that this delay, spreading, and smearing may have led to an underestimate. He explains that the trickling of information "may have tended to diffuse the effect of specific disclosures." Ex. 2 at 4 ¶ 17. He explains that where the

information has been spread, "the price reactions to specific disclosures tend to be smaller than if all the information came out in a single disclosure on a single event date." Ex. 2 at 4 ¶ 17. Professor Fischel does not dispute this conclusion in his rebuttal report.

Accordingly, the Court should find that the trickling of information—for which Nacchio was directly responsible—likely means that any event study leads to an underestimate of the Defendant's gain. The Court thus should find that the gain amounts reflected in Professor Thakor's event study are conservative.

In addition, the Court should hold Nacchio responsible for any uncertainty. As noted above, courts calculating disgorgement generally hold the defendant responsible for any uncertainty. That principle is especially appropriate here, given that a great deal of uncertainty in the event study is attributable to Nacchio's own actions in delaying, smearing, confounding, and spinning the ultimate disclosure of the information at issue in this case.

VI. THE DEFENDANT'S MOST RECENT CALCULATION OF GAIN SHOULD BE REJECTED AS UNRELIABLE.

Professor Fischel has also submitted the results of another calculation regarding Qwest's stock price in 2001. Ex. 34 (Fischel resentencing report). The results of this measurement purport to show that the Defendant gained $0 from the offense.

This approach should be swiftly rejected. Professor Fischel's report makes clear that the parameters he used are not derived from any scientific method. Professor Fischel does not even attempt to suggest that this measurement is based on any accepted economic methodology. Most importantly, the measurement is an unscientific approach that is based on unjustified empirical assumptions.

Professor Fischel's Resentencing Report indicates that both the data and the method for this measurement were suggested by defense counsel. Professor Fischel explains that he "was asked to calculate the portion of Mr. Nacchio's sales proceeds, if any, which could be attributed to inside information under the assumption that any benefit to Mr. Nacchio would be measured by the cumulative dollar difference in performance on the dates of the Four Subsequent Disclosures ... I was also asked to perform this calculation using 2, 3, and 4 day windows beginning on these dates." Ex. 34 at 3 ¶ 5. This suggests that defense counsel chose the methodology, the assumption, the dates, and the windows.

Professor Fischel does not even attempt to claim that this methodology, its assumptions, and the dates are based on some acceptable economic method. He simply "reports the results of these calculations." *Id.* at 3 ¶ 5. Notably, Professor Fischel provides no explanation of why he used just four dates, excluding one of the five he used in his event study.

In any event, the measurement is empirically unjustified. As Professor Thakor explains, this methodology is not an event study. Ex. 5 (Thakor rebuttal) at 3-4 ¶ 6. First, this new approach does not make any attempt to determine the historical relationship between Qwest stock and the index used. Instead, it assumes that "each one percent movement in the NASDAQ Telecom Index explains a one percent movement in Qwest stock." *Id.* at 3-4 ¶ 6. This assumption is unjustified. Second, this approach makes no attempt to control for broad market factors or company-specific factors unrelated to the issues in this case. *Id.* at 3-4 ¶ 6. Third, this methodology uses a different comparison

index than Professor Fischel chose for his event study. Professor Fischel does not explain or justify this modification. *Id.* at 3-4 ¶ 6.

Finally, Professor Fischel offers no reason why this additional analysis was conducted. Given that he had already performed a more complex event study, it cannot be justified on price grounds. And he makes no claim that it is somehow more accurate than his event study. In any event, this approach is an unscientific and an unreliable one, and the Court should reject it.

VII. OTHER FACTORS SUPPORT A FINDING OF A SUBSTANTIAL GAIN.

Other factors lend further support to the reasonableness of Professor Thakor's conclusions regarding gain.

A. The dramatic decline in Qwest's stock price shows that Professor Thakor's calculation of gain is conservative.

The Government submits that the steep decline of Qwest stock supports the conclusion that Professor Thakor's calculation is a fair and conservative one. Professor Thakor does not calculate Nacchio's gain based on the total decline in the stock price from 2000 to 2001. The stock price dropped from approximately $38 at the time of Nacchio's 2001 trades to just over to $1 per share by July 2002. *See* Ex. 3 (Qwest stock price chart). Instead, Professor Thakor estimates that the decline attributable to the disclosures was 45% to 63%.

Professor Thakor's approach suggests that if all of the material nonpublic information at issue had been disclosed at once, the stock price would have declined by 45% to 63%. In other words, the stock price, having absorbed all of that information, would have been not $38 per share but approximately between $12 and $21 per share.

This assessment is very conservative given that Qwest's stock price declined far more than that overall, and given that since 2001, Qwest stock has never climbed to those levels again. In other words, there has been no price rebound of Qwest's stock price that would call Thakor's gain calculation into question.

B. Professor Thakor's calculation of gain is consistent with Nacchio's own prediction about how the stock price would react to the information.

Stocks with higher growth potential are valued higher. Thakor Report at 15-16 ¶ 45 & n.35. Nacchio understood this principle. He repeatedly stated that Qwest's growth was "very important" because Qwest held itself out "as a growth company." Ex. 9 (Szeliga) at App. 2109. He spoke "on several occasions" describing Qwest as "a growth company." *Id.* at App. 2117. He recognized that if analysts did not see Qwest as a growth company, its stock would greatly suffer. He believed that Qwest needed to "grow or die" (GX 514A (video exhibit) and that if Qwest missed its growth targets, it would get "whacked" (GX 506A (video exhibit); *see* Ex. 9 (Szeliga) at App. 2117-2122. He also understood that the telecommunications market was "skittish" and "mercurial." GX 559A.

Most significantly, Nacchio himself estimated that even a small miss of the growth targets would result in the market harshly punishing the stock price. Nacchio specifically predicted that a $50 million, or 0.2%, miss in the $21.3 billion target would cause the stock price to drop at least 15% to 20%. This prediction by Nacchio further bolsters the conclusion that the proper gain amount should be well in excess of 15-20%. *Cf.* S. Buell, *Reforming Punishment of Financial Reporting Fraud*, 28 Cardozo L. Rev. 1611, 1641 (Feb. 2007) (cited in *Nacchio*, 573 F.3d at 1079 & n.14, 1085) (suggesting that one

possible approach to measuring loss from securities fraud is "to determine the amount of loss that was 'foreseeable' to the defendant"). Nacchio obviously would have known that a much bigger miss would mean a much larger price decline. Specifically, he knew if Qwest missed its targets by not just $50 million but instead vastly more --- more than $1 billion — and if this miss was due to a much lower growth rate than analysts expected, the stock price would decline far more than 15-20%. Nacchio's own prediction thus is entirely consistent with Professor Thakor's estimate of a decline of 45-63%.

CONCLUSION

The Government submits that the presumptive gain, calculating using the disgorgement methodology, exceeds $50 million. The Government further submits that if the Court elects to use an event-study approach, it should conclude that the gain was at least the $32.9 million figure calculated by Professor Thakor.

Respectfully submitted this 12th day of January, 2010.

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CERTIFICATE OF SERVICE

I hereby certify that on this 12th day of January, 2010, I electronically filed the foregoing with the Clerk of the Court using the CM/ECF system which will send notification of such filing to the following e-mail addresses:

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