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Does high-quality corporate communication reduce insider trading profitability?

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ABSTRACT

Exploring a unique database on insider trading in Belgium, we investigate whether high-quality corporate communication contributes to reducing insider trading profitability and information asymmetry. Using disclosure scores of professional financial analysts as a proxy for communication quality, we find a significant negative association between corporate communication quality and insider trading profitability. Closer inspection of different communication channels shows that the quality of annual reports, press releases and investor relation activities is more relevant in explaining insiders' abnormal returns than the quality of corporate websites.

1. Introduction

This paper examines whether high-quality communication is effective in reducing the profitability of insider trading. Previous research has documented that, despite regulations on insider trading, insiders still earn significant abnormal returns from trading on information asymmetries between insiders and outsiders. As suggested by analytical work on disclosure (e.g. Diamond, 1985; Verrecchia, 2001), an important instrument to decrease this asymmetry could be the dissemination of high-quality information. We therefore hypothesize that high-quality corporate communication reduces insiders' abnormal returns.

In an additional analysis this paper also examines whether the impact of disclosure quality differs between communication channels, i.e. annual reports, press releases, websites and investor relation activities. The different channels and information communicated through these channels have specific characteristics that might limit or enhance the ability to affect the level of information asymmetry, like, for example, timeliness of the disclosed information, time horizon (forward-looking versus backward-looking), need for external verification and voluntary or mandatory disclosures. We therefore hypothesize that the impact of disclosure quality on insider trading profits and on information asymmetry in general depends on the communication channel. Results on the effectiveness of the different communication channels and especially on the difference between semi-mandatory (i.e. annual reports)[1] and voluntary channels (i.e. press releases, websites, investor relations) might also be of interest to regulators as they might indicate potential areas of improvement for mandatory disclosure requirements. These requirements are imposed by regulators to prevent information asymmetries and stimulate a more efficient allocation of resources.

Within the extensive literature on insider trading, an important line of research has focused on the determinants of insider trading profitability. Early studies by Jaffe (1974) and Finnerty (1976) identified company risk factors like size and the market-to-book ratio as important drivers of insiders' abnormal returns. Building on these findings, later studies attempted to broaden the scope of analysis and considered additional firm and trade characteristics. For example, some researchers examined whether the informational benefit of insiders is related to their position within a company (e.g.

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[1] Information included in annual reports consists of mandatory financial statements information possibly supplemented by voluntary disclosures on business segments, future prospects, company objectives, etc.

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Betzer & Theissen, 2009; Fidrmuc, Goergen, & Renneboog, 2006; Seyhun, 1986). Others investigated the influence of the debt-to-asset ratio (Aussenegg & Ranzi, 2008), trade size (Cheuk, Fan, & So, 2006; Seyhun, 1986; Wisniewski & Bohl, 2005), trade intensity (Aussenegg & Ranzi, 2008; Betzer & Theissen, 2009) and cross-listing on foreign stock markets (Chang & Corbitt, 2012; Korczak & Lasfer, 2008). More recently, as researchers and practitioners emphasized the importance of good corporate governance in managing the information asymmetry problem, insider trading research started to consider corporate governance related variables. Accordingly, previous studies have looked into the effect of ownership concentration (Betzer & Theissen, 2009; Del Brio & Perote, 2007; Fidrmuc et al., 2006), type of controlling shareholder (Betzer & Theissen, 2009), board composition (Chang, Hillman, & Watson, 2005) and executive compensation (Zhang, Cahan, & Allen, 2005). Nevertheless, while it is generally acknowledged that comprehensive, transparent and timely disclosures are essential elements of good corporate governance (Bushman & Smith, 2001; Mallin, 2002; Mitton, 2002; OECD, 2004; Patel & Dallas, 2002), no prior study has thoroughly investigated the effect of the quality of corporate disclosures on insider trading returns. In this study, we examine this relation by relating professional analysts' disclosure scores to the profitability of insider trading.

To address our research question, we use data from Belgian listed companies. La Porta, Lopez-de-Silanes, Shleifer, and Vishny (1997) and La Porta, Lopez-de-Silanes, Shleifer, and Vishny (1998) depict Belgium as an insider economy characterized by highly concentrated and controlling ownership. In such an environment, minority shareholders are at a disadvantage as large, dominant shareholders can use their power to privately acquire information, which makes them less dependent on public communication. As a consequence, in Belgium, the role of corporate communication in reducing information asymmetry is potentially very important.

To measure the quality of corporate communication, we use a disclosure score granted by the Belgian Association of Financial Analysts (BVFA).[2] Each year, the BVFA invites its members to screen the communication of a number of companies and assign a disclosure rating. This rating evaluates several disclosures characteristics identified as important attributes of high-quality communication, i.e. preciseness, transparency, timeliness and scope (Brown & Hillegeist, 2007). Contrary to comparable analyst ratings, like those assigned by Standards and Poor's (S&P) and the Association for Investment Management and Research (AIMR) (Brown & Hillegeist, 2007; Khanna, Palepu, & Srinivasan, 2004; Patel, Balic, & Bwakira, 2002; Welker, 1995), the BVFA also evaluates the communication quality of smaller companies. For these companies, information asymmetries between insiders and other market participants are potentially more significant, which makes high-quality communication even more relevant (BVFA, 2010a).

To measure the profitability of insider trading, we exploit a unique database on insider trading provided by the Belgian Financial Services and Markets Authority (FSMA) and calculate the cumulative abnormal returns that insiders earn when trading in their own stock. Since the liquidity of some Belgian listed securities is rather low (Buysschaert, Deloof, & Jegers, 2004), the abnormal returns are estimated either using a standard market model (MacKinlay, 1997) or market model adjusted for thin trading (Dimson, 1979) depending on whether stocks are thinly traded or not.

Based on a sample of insider trades that occurred between January 2006 and August 2010, our results show that high-quality communication reduces the profitability of insider trading. Furthermore, we find that the quality of annual reports, press releases and investor relation activities, is relatively more effective in reducing information asymmetry than the quality corporate websites. Investor relation activities, which are used to communicate timely and forward-looking information directly to the investor community, appear to be the most effective.

Our research contributes to two streams of literature. First, we add to the literature on insider trading profitability by examining the impact of high-quality communication, as proxied by a comprehensive measure of disclosure quality assigned by professional users of corporate communication. To our knowledge, there are only a handful of papers that investigate whether corporate communication quality influences insiders' informational benefits. In addition, these papers obtain inconclusive results and use indirect measures of reporting quality, such as analyst following, news coverage and value relevance (e.g. Frankel & Li, 2004). In contrast to these studies, we use a more direct and objective measure of corporate communication quality assigned by professional users of corporate communication, i.e. financial analysts and fund managers. In addition, our measure includes an individual assessment of the quality of annual reports, press releases, websites and investor relation activities. This allows us to assess whether the effect of the quality of communication differs across alternative communication channels. A general advantage of using externally-developed disclosure ratings is that these do not involve judgment by the researcher(s) in question. This facilitates the verification of research results and the application of the rating in other research designs (Healy & Palepu, 2001). In addition, researchers only have access to published information and lack knowledge of disclosures distributed through unpublished channels like analyst meetings and conference calls (Healy & Palepu, 2001). Analysts are also regarded as the primary and most influential users of corporate communication as they communicate with companies on a daily basis (e.g. Hirst, Koonce, & Simko, 1995; IASB, 2005; Revsine, Collins, & Johnson, 2004; Schipper, 1991). This puts them in a privileged position to objectively evaluate the quality of corporate disclosures.

Second, our work contributes to the literature examining the relationship between disclosure and information asymmetry by using an alternative proxy for information asymmetry. Prior work examined this relation using, for example, bid-ask spreads and the probability of informed trading as proxies for information asymmetry (e.g. Brown & Hillegeist, 2007; Welker, 1995). By contrast, we proxy information asymmetry by the magnitude of insiders' abnormal returns. The use of this proxy is well-established in the empirical literature (e.g. Chang et al., 2005; Frankel & Li, 2004) and supported by theoretical work (Kyle, 1985). Furthermore, the majority of prior disclosure studies is based on U.S. data (Healy & Palepu, 2001). Re-examining the disclosure–information asymmetry relation for a sample of Belgian listed companies may provide valuable new insights as the Belgian institutional setting differs from the U.S. For example, with regard to ownership structures, Belgian listed companies generally have a concentrated and controlling ownership (La Porta et al., 1997, 1998). In addition, they are often controlled by a family or a single controlling owner (Faccio & Lang, 2002). U.S. companies, on the other hand, tend to have diffuse ownership and are less (family-) controlled. Regarding the provision of external capital, Belgian companies primarily raise external capital through bank financing while their U.S. counterparts generally rely an equity financing (La Porta et al., 1997). Obviously, information needs of both capital providers differ substantially. Other institutional differences include the weaker level of investor protection (La Porta et al., 1998) and the influence of corporate law and taxation on financial reporting in Belgium (Vanstraelen, Zarzeski, & Robb, 2003). The above characteristics of the Belgian institutional environment do on the other hand bear a strong resemblance to the economies of other continental

[2] BVFA stands for "*Belgische Vereniging van Financiële Analysten*".