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Insider trading activity, tenure length, and managerial compensation ☆

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In this study, insider trading activity is used as part of a managerial compensation structure. The wage structure changes with the tenure duration of the insider. Managers with shorter tenure rely more on insider profits as part of their compensation. On the other hand, managers with longer tenure execute insider transactions with lower profits. Different measurements of insider profits using calendar day returns of insider transactions, holding period returns for different horizons, or weighted average cumulative abnormal returns for the executive all lead to the same conclusion. The results are robust to various well-known empirical models, such as the CAPM model, the Fama and French (1993) three factor model, or the Carhart (1997) four factor model. Insider trading profits have increased in recent years overall, especially after the Securities and Exchange Commission (SEC) implementation of Rule 10b5-1 in 2000. Therefore, the design of a wage schedule incorporating insider trading activity has become more relevant.

1. Introduction

An important part of the governance structure of a firm is the choice of the compensation contract for managers. Ideal executive compensation has been the subject of extensive prior research (see Core, Guay, & Larcker, 2003, for an excellent survey). The insider-manager (the agent) should perform in the best interest of the shareholders. The problem, as in all agency models, is that the effort exerted by the manager is not observable. In this study, the principal-agent problem is accounted for by using insider trading activity as a proxy for managerial effort in order to design the optimal managerial contract.

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The primary advantage of insider trading is that it provides firms' owners with important information regarding managers' contributions to the firm.[1] Observation of the insider trading activity may help to at least partially sort out superior managers. Distinguishing the quality of the managers by following their trading activity would accomplish the design of more effective compensation systems for these managers. Insider purchase activities reward those who add value to the firm through their superior effort, proper risk assessment, and willingness to take justifiable risks. Such managers would also be willing to have compensation schedules at least partially based on their trading activity. The theoretical model in this paper utilizes the observable insider trading activity as a proxy for the unobservable managerial effort to address the moral hazard problem.

Jaffe (1974), Finnerty (1976), Seyhun (1986, 1998), Rozeff and Zaman (1988), Lakonishok and Lee (2001), and Garfinkel, Kahle, and Shastri (2007) find that informed trades have long term (6-month to 3-year) predictive power. Empirical studies by Seyhun (1992b), Bushman, Piotroski, and Smith (2005), Roulstone (2003), Garfinkel et al. (2007), among many others have shown that insider trading is widespread in the U.S. Furthermore, according to Carlton and Fischel (1983), shareholders do not restrict insider trading in the company code of ethics or employment contracts. An examination of the corporate charters of randomly selected companies reveals that at least half of those firms do not mention either insider trading or the misuse of confidential information according to Seyhun (1992a). Roulstone (2003) finds that firms with stricter insider trading restrictions pay a premium in total compensation compared to firms with fewer restrictions. Henderson (2011) documents that firms restricting insider trading provide higher traditional compensation. On the other hand, firms liberalizing insider trading provide lower traditional compensations. One can conjecture that firms implicitly consider insider trading activity while designing executive compensation structures.

The argument in this study is based on the insiders' ability to create private information by making real production decisions. These production decisions have a financial impact on the firm. Insiders trade at financial markets and the information on production decisions eventually becomes public resulting in stock price changes that profit the insider. Essentially, the insider creates private information based on his/her actions in the firm. And by allowing the insider to work at the firm, the owner provides an opportunity to the insider to create private information and to profit.

It is clear that an insider's compensation at a firm is not necessarily only monetary. Working at the firm creates value to the insider through enhanced experience, skills, networking, access to information, and the ability to create private information. Accessing and creating information are advantages that can be exploited directly at financial markets for profit. The insider can decide the effort level on the project, which in turn will influence the outcome of the project. The compensation arrangement utilizing insider trading as the signal for managerial effort does take this issue into account in this study.

The tenure length of the executive at the firm also affects his/her trading activity. Cohen, Malloy, and Pomorski (2012) show that insiders with longer tenure trade differently than insiders with shorter tenure. There is in fact a large literature on dynamic contracting that explains why agents earn less in the beginning of their careers. Thomas and Worrall (1988) and Ray (2002) develop theoretical frameworks showing that efficient wage contracts are not stationary and that the wage structure has dynamic and evolving stochastic characteristics. One can conjecture that if the insider has worked for a relatively short period at the company, the base compensation will be modest as in Thomas and Worrall (1988). To complement the base compensation, the insider will be involved in heavier insider trading activity. As the tenure of the insider at the firm increases, so will the base compensation, official bonuses, and perquisites. The insider will be less inclined to augment the compensation with trading activity. Furthermore, because the insider's position becomes more visible with his longer employment, he will be more cautious since he will be scrutinized more by regulatory authorities and he will not want to forego his high traditional compensation by engaging in insider trading that may be construed as illegal.

[1] While using insider trading as part of the wage structure of a manager helps achieve better alignment of owner and manager interests, aligning risk preferences of owners and managers is a more difficult task. Low (2009) provides empirical evidence that managerial risk aversion is a serious agency problem. Boyle (1984), Beatty and Zajac (1994), Gray and Cannella (1997), and Coles, Daniel, and Naveen (2006) provide evidence that executive compensation may be designed to achieve this goal but Ross (2004) documents that even giving options to insiders will not necessarily make them more willing to take appropriate risks.