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Insider trading and performance of seasoned equity offering firms after controlling for exogenous trading needs

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Abstract

Insiders trade not only because they have private information about their companies but also because of other exogenous reasons. Therefore, it is important to control for exogenous trading needs in empirical studies regarding insider trading. Lee (1997) shows that insider trading is not closely related to the long-term performance of primary seasoned equity offering firms. This paper examines whether the results hold after controlling for exogenous needs to trade by using an inequality test with instrumental-variables technique. © 2002 Board of Trustees of the University of Illinois. All rights reserved.

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1. Introduction

Insiders trade not only because they have private information about their companies' future performance but also because of many other exogenous needs to trade (e.g., house down payments, college tuition payments for the kids, payments related to divorce settlements, seed money for a new business, and hostile takeover defenses). For example, Hulbert discusses the problems related to an investment strategy using inside trading information, and emphasizes that insider trading is motivated not only by inside information about the

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firm but also by personal reasons not related to special knowledge about the firm [*Forbes* (August 15, 1994, page 145)]. However, most empirical studies in the insider trading literature [Jaffe (1974), Finnerty (1976), Elliot, Morse, and Richardson (1984), Givoly and Palmon (1985), Seyhun (1986), Rozeff and Zaman (1988), Lin and Howe (1990), John and Lang (1991), and Lee (1997) among others] do not control for exogenous trading needs. This is not because they do not recognize the importance of exogenous trading needs, but because it is hard to control for unobservable exogenous trading needs.

Here, an inequality test with instrumental variable method (ITIV) is introduced as one way to control for exogenous trading needs in empirical studies regarding insider trading. As an example, the ITIV method is used to control for exogenous trading needs in the examination of the relation between pre-issue insider trading and the post-issue long-run performance of primary seasoned equity issuing companies. Lee (1997) shows that there is no close relation between insider trading and the long-run performance of primary seasoned equity issuing firms. Lee points out that the poor relation might be due to the fact that exogenous trading needs are not controlled for in the study. It is shown that the ITIV method can be used to examine this issue.

The rest of the paper is organized as follows. Section 2 describes the data and summary statistics, and Section 3 presents the inequality test with instrumental variables methodology. Finally, Section 4 summarizes the results and presents some concluding remarks.

2. Data and summary statistics

The sample consists of primary seasoned equity offerings during 1976–1990 that have been recorded by the Securities Data Company (SDC). Similar to Lee (1997), the following firms are excluded from the original SEO sample: 1) firms which do not have price records on the CRSP daily NYSE/Amex or Nasdaq tapes on their offering date; 2) utility companies (SIC codes 4910–4949), closed-end mutual funds (SIC codes 6720–6739) and real estate investment trusts (REITs: SIC code 6798); 3) firms which do not have any insider trading for the 6 months ending on, and including, the issue date; and 4) firms that do not have book equity value for the fiscal year before their SEOs in any of the following data sources: COMPUSTAT, Moody's various manuals, and Standard and Poor's Stock Report. An SEO is also excluded if more than half of the total offering consists of secondary shares (shares sold by existing shareholders). Finally, any SEOs by the firms that have issued seasoned shares during the prior 36-month period are excluded. 1,281 SEOs are in the sample. Fig. 1A presents the annual volume of SEOs in the sample for each year during 1976–1990. Note that there are large variations in the volume of SEOs during this sample period.

The insider trading data is from the Securities and Exchange Commission's (SEC) *Ownership Reporting System* (ORS) data file that contains all transactions by insiders subject to disclosure according to the Securities and Exchange Act of 1934. Insiders are defined as officers, directors and controlling persons, and insider trading activity includes both open market and private transactions.

Five prior return, size and book-to-market equity ratio-adjusted matching firms are used as a benchmark. The same selection procedures as those described in Lee (1997) are used.