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Journal of Banking & Finance 24 (2000) 395–425

Journal of BANKING & FINANCE

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Insider trading and the voluntary disclosure of information by firms

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Received 4 July 1995; accepted 30 March 1999

Abstract

We examine the voluntary disclosure policy of a firm where the manager has private information and opportunities to trade on it. The equilibrium disclosure policy ranges from full disclosure to partial disclosure to nondisclosure depending on whether the manager's pay–performance sensitivity is high, medium or low, respectively. In the partial disclosure equilibrium, good news is more likely to be disclosed early than bad news and insiders are more likely to sell than buy shares, two results for which there is ample empirical support. The likelihood and amount of voluntary disclosure increases with the manager's pay–performance sensitivity, firm quality, and the number of insiders privy to the information and decreases with market liquidity. Stringent enforcement of insider trading regulations induces more disclosure by firms whereas the short sales prohibition on insiders induces less disclosure. © 2000 Elsevier Science B.V. All rights reserved.

JEL classification: G30; G38

Keywords: Disclosure; Insider trading

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PII: S 0 3 7 8 - 4 2 6 6 (9 9) 0 0 0 4 3 - 6

1. Introduction

It is generally accepted that corporate managers have access to private information which they can and do use to trade profitably in their firms' securities. [1] In this paper, we examine the question: how much of this private information about their firms will managers *voluntarily* disclose in light of the potentially large profits they can make if they withhold disclosure?

The issue of voluntary disclosure has attracted the attention of researchers in accounting, economics and finance. A seminal result in this area, due to Grossman (1981) and Milgrom (1981), is that in a market with rational expectations and *costless* disclosure, firms will voluntarily disclose *all* information. Intuitively, the market knows that firms want to disclose good news and withhold bad news and so it will rationally interpret nondisclosure as bad news ("no news is bad news"). Therefore, the market will drive down the stock prices of nondisclosing firms precipitously till they disclose their information. In effect, the market suspects the worst of nondisclosing firms, causing their stock prices to drop to the lowest possible level, so that even the firm with the least favorable information has no incentive to withhold it. However, this full disclosure result is inconsistent with the prevalence of government-mandated disclosure requirements on firms and with the widely-held belief that managers do exercise discretion in disclosure.

Verrecchia (1983) shows that the full disclosure argument unravels when disclosure is costly. [2] He considers a model where firms incur a fixed, exogenous disclosure cost and shows that, in equilibrium, they will disclose only when their news is sufficiently good, for only then is it worth their while to incur the disclosure cost. In this model, nondisclosure does not necessarily imply that the firm has bad news; rather, it could imply that the firm has good news, but the news is not good enough to incur the disclosure cost. However, the available empirical evidence is not consistent with all of the model's predictions. For example, the model predicts that, in an industry in which all firms are potential recipients of information, disclosure by one firm should lead to a stock price decline for nondisclosing firms since only firms with relatively good news disclose their information. But Lev and Penman (1990) find no stock price reaction for nondisclosing firms and Foster (1981) and Clinch and Sinclair (1987) find that stock prices of nondisclosing firms actually increase. Additionally, we see that firms sometimes withhold *good* news even when there is no obvious disclosure cost, contrary to this model's predictions. For example, Texas Gulf

[1] Jaffe (1974) and Seyhun (1986) are just two examples of the many studies that show evidence of abnormal trading profits to corporate insiders.

[2] For example, firms with proprietary information may find disclosure costly because it can hurt their competitive positions in their industries.

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