Journal of Corporate Finance 18 (2012) 598–625

Contents lists available at SciVerse ScienceDirect

Journal of Corporate Finance

journal homepage: www.elsevier.com/locate/jcorpfin

Insider trading in takeover targets

Anup Agrawal [a,*], Tareque Nasser [b]

[a] Culverhouse College of Business, University of Alabama, United States
[b] Department of Finance, Kansas State University, United States

ARTICLE INFO

Article history:
Received 24 May 2011
Received in revised form 22 February 2012
Accepted 24 February 2012
Available online 3 March 2012

JEL classification:
G14
G18
G34
K22

Keywords:
Insider trading
Takeovers
Takeover targets
Mergers and acquisitions

ABSTRACT

We examine open market stock trades by registered insiders in about 3700 targets of takeovers announced during 1988–2006 and in a control sample of non-targets, both during an 'informed' and a control period. Using difference-in-differences regressions of several insider trading measures, we find no evidence that insiders increase their purchases before takeover announcements; instead, they decrease them. But while insiders reduce their purchases below normal levels, they reduce their sales even more, thus increasing their *net* purchases. This 'passive' insider trading holds for each of the five insider groups we examine, for all three measures of net purchases, and is more pronounced in certain sub-samples with less uncertainty about takeover completion, such as friendly deals, and deals with a single bidder, domestic acquirer, or less regulated target. The magnitude of the increase in the dollar value of net purchases is quite substantial, about 50% relative to their usual levels, for targets' officers and directors in the six-month pre-announcement period. Our finding of widespread profitable passive trading by target insiders during takeover negotiations points to the limits of insider trading regulation. Finally, our finding that registered insiders of target firms largely refrain from profitable active trading before takeover announcements contrasts with prior findings that insiders engage in such trading before announcements of other important corporate events, and points to the effectiveness of private over public enforcement of insider trading regulations.

1. Introduction

Being acquired is one of the biggest events in the life of a company. Perhaps not surprisingly, takeovers are one of the most researched topics in finance.[1] One of the principal findings of this research is that target stock goes up dramatically, on average by about 30%, upon takeover announcement. This substantial and almost instantaneous increase in stock price provides a tempting trading opportunity to corporate insiders, who often have knowledge of takeover negotiations months in advance of its public announcement. Anecdotal evidence suggests that a great deal of insider trading takes place before takeover announcements. For example, in August 2006, the *New York Times* reported that securities of over 40% of the companies receiving buyout bids exhibited suspicious trading in the weeks before the deals became public (see Morgenson, 2006).

Consequently, takeovers have been a major focus of regulatory efforts against insider trading. For instance, of the two biggest insider trading cases ever prosecuted in the U.S., almost all of the charges in the Levine–Boesky–Milken case in the late 1980s and many of the charges in the Galleon hedge fund case in 2009, relate to insider trading in takeover targets (see, e.g., Bray, 2010; Frantz, 1987; Sharma and Pulliam, 2009; Strasburg and Bray, 2009). Furthermore, about 80% of the cases in Meulbroek's (1992,

* Corresponding author at: Tuscaloosa, AL 35487-0224, United States. Tel.: +1 205 348 8970; fax: +1 205 348 0590.
E-mail addresses: aagrawal@cba.ua.edu (A. Agrawal), tnasser@cba.ua.edu (T. Nasser).

[1] Jensen and Ruback (1983), Jarrell et al. (1988), Andrade et al. (2001), Holmström and Kaplan (2001), and Betton et al. (2008) provide excellent reviews of this literature.

0929-1199/$ – see front matter © 2012 Elsevier B.V. All rights reserved.
doi:10.1016/j.jcorpfin.2012.02.006

p. 1669) sample of insider trading cases prosecuted by the U.S. Securities and Exchange Commission (SEC) during 1980–1989 are takeover-related.

This paper provides systematic evidence on the level, pattern and prevalence of open market stock trades by registered insiders (i.e., corporate officers, directors, and large blockholders) in takeover targets. This issue is important for at least three reasons. First, policy makers and regulators have a special interest in the trades of these 'ultimate' insiders who are likely to have detailed, ongoing knowledge of a firm's activities. Second, as discussed in Sections 5 and 7 below, an examination of this issue sheds some light on the efficacy of alternate mechanisms (public vs. private) used to enforce two different regulations against insider trading, SEC rule 10b-5 and Section 16b of the Securities Exchange Act of 1934. While pre-announcement trading by registered insiders before any major corporate event is subject to rule 10b-5, such trading in merger targets can also be subject to Section 16b because of the forced stock sale that occurs in mergers, as pointed out by Agrawal and Jaffe (1995) — see Section 3.1 below. While rule 10b-5 is enforced by the SEC, Section 16b is enforced by private attorneys. Finally, recent high-profile corporate scandals such as Enron, Worldcom and HealthSouth, and the consequent adoption of tough governance rules under the Sarbanes–Oxley Act and under listing requirements of the NYSE, Nasdaq and AMEX have focused investor, media and regulators' attention on the activities of these insiders. This raises the question of whether insiders change their trading behavior in response to greater scrutiny of their activities.

Surprisingly, despite the obvious importance of this issue and large waves of takeovers in recent decades, there is little systematic evidence on whether the level and pattern of profitable insider trading before takeover announcements (i.e., increase in purchases or reduction in sales) is abnormal for a broad cross-section of targets of takeovers during modern times (i.e., after 1961). This paper aims at filling this gap in the literature and provides large-sample evidence on this issue.

We examine the level and pattern of insider trading in about 3700 targets of takeovers announced during 1988–2006 and in a control sample of non-targets, both during an 'informed' and a control period. We analyze open-market stock transactions of five groups of corporate insiders, defined in Section 4.4 below: top management, top financial officers, all corporate officers, board members, and large blockholders. We separately examine their purchases, sales and net purchases in target and control firms during the one year period prior to takeover announcement (informed period) and the preceding one year (control) period, using a difference-in-differences (D-i-D) methodology. Using several measures of the level of insider trading, described in Section 5.1 below, we estimate cross-sectional regressions that control for other determinants of the level of insider trading.

We find an interesting pattern in the average trading behavior of target insiders over the one year period before takeover announcement. We find no evidence that insiders increase their purchases before takeover announcements. Instead, while they reduce their purchases below normal levels, they reduce their sales even more, thus increasing their *net* purchases. This pattern is confined to the six-month period before takeover announcement; it holds for each insider group, and for all three measures of net purchases that we examine. The economic magnitude of this effect is quite substantial. Over the six-month pre-announcement period, our D-i-D regression estimates indicate an increase of about 50% in the dollar value of net purchases of targets' officers and directors relative to their usual net purchase levels, after controlling for other factors. These effects are even stronger in certain sub-samples with less uncertainty about takeover completion, such as friendly deals, and deals with a single bidder, domestic acquirer, or less regulated target.

Our conclusions are tempered by two caveats that apply to most studies of trading by registered insiders.[2] First, we assume that insiders report their trades to the SEC as required by law. Second, insiders may trade via friends or extended family members (outside their immediate families), who are not required to report their trades.

While prior studies find that stocks sold by insiders underperform stocks bought by them (see, e.g., Cheng et al., 2007; Jaffe, 1974; Rozeff and Zaman, 1988; Seyhun, 1986), the literature on insider trading before major corporate events presents somewhat mixed findings. While insiders appear to trade profitably before many corporate events such as Chapter 11 bankruptcy filings, stock repurchases, seasoned equity offerings, earnings announcements, dividend initiations, and earnings restatements, insiders of acquiring firms appear to refrain from profitable trading before merger announcements (see, e.g., Seyhun and Bradley, 1997; Lee et al., 1992; Karpoff and Lee, 1991; Penman, 1985; John and Lang, 1991; Agrawal and Cooper, 2008; Seyhun, 1990, respectively).[3]

Meulbroek (1992, p.1663) argues that trades reported to the SEC by registered corporate insiders under Section 16a, such as the trades we study here, are legal insider trades that "are by definition not based on material, non-public information." She assumes that if these insiders make a trade based on material non-public information, prohibited by SEC Rule 10b-5, they will not report it to the SEC. There are several reasons to question the validity of this assumption. First, if insiders fail to report such trades, they are in violation of Section 16a. Second, the intense investor focus on trades reported by registered insiders (see, e.g., Seyhun, 1998, p. xx) suggests that investors believe such trades to be informed. Third, a large finance literature, cited above, that finds that registered insiders trade profitably before important corporate events suggests that reported insider trades are informed, on average. It is hard to argue that top executives and directors first learn about major events involving their companies from news reports in the media[4] and it is hardly surprising that their trades are profitable. Fourth, the recent law and economics literature on the efficacy of private securities litigation uses the existence of reported insider trades as an indicator of the merit of a securities lawsuit (see, e.g.,

[2] An exception is Meulbroek (1992), who examines insider trading uncovered by, rather than reported to, the SEC. Bhattacharya and Marshall (2012) find that top executives prosecuted by the SEC for insider trading tend to be wealthier and better-paid, implying that they do not violate the law only for the money.

[3] In addition, the early study by Elliott et al. (1984) finds that insiders trade in the profitable direction before most corporate news announcements (see their Table 5), although the effects are statistically significant only for some news (Table 4). And Givoly and Palmon (1985, Table 4) find that insider purchases or sales are followed by corporate news over the next one month only about one-third of the time, of which about one-half of the news is neutral, and the remaining is good or bad in roughly equal measure.

[4] In rare instances where that happens, the insiders in question are often about to become outsiders and become targets of news reports themselves!