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Do voluntary corporate restrictions on insider trading eliminate informed insider trading?[☆]

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ABSTRACT

We investigate whether voluntary corporate restrictions on insider trading effectively prevent insiders from exploiting their private information. Our results show that insiders of firms with seeming restrictions on insider trading continue to take advantage of positive private information while being more cautious when exploiting negative private information. The results suggest that insiders continue to exploit their informational advantages in a way that minimizes their legal risk. We also find that the degree of information asymmetry is significantly lower in firms with restriction policies and that corporate governance significantly affects firms' decisions to adopt these policies.

1. Introduction

Over the last twenty five years or so, there has been a series of changes in the regulatory environment regarding insider trading,[4] which has made firms pay closer attention to insider transactions. In particular, the Insider Trading and Securities Fraud Enforcement Act (ITSFEA) passed by Congress in 1988, and the Stock Enforcement Remedies and Penny Stock Reform

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4 Insiders are not allowed to trade based on material inside information according to Section 10(b) of the Securities Exchange Act of 1934. Nevertheless, many studies have documented that insider trading contains information regarding future stock returns (for example, Seyhun, 1986, 1992; Lin and Howe, 1990; Meulbroek, 1992; Rozeff and Zaman, 1998; Lakonishok and Lee, 2001). In early 2000, as a part of its final rules surrounding Regulation Fair Disclosure (FD) that changed both the timing and content of earnings information released by companies, the Securities and Exchange Commission reiterated the importance of insiders not trading based on material non-public information (for example, Bailey et al., 2003). In addition, the Sarbanes–Oxley Act which took effect in August 2002, also increased the scrutiny associated with insider trading by tightening the reporting requirements associated with insider transactions.

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Act (SERPSRA) passed in 1990 effectively rendered firms and their top management responsible for their employees' illegal trading.[5]

In response, firms have started to voluntarily adopt corporate policies that restrict their insiders from freely trading their stock in order to reduce their own legal risk, with many of these policies typically specifying certain time windows during which insiders are allowed to trade their stock. Outside of the allowed periods, which are usually described as blackout periods, insiders are basically restricted from trading without pre-clearance from their firms. In most instances, firms choose short time windows after the quarterly earnings announcement dates as allowed periods, with many requiring their insiders to obtain pre-approvals even when they trade during the allowed time periods.[6]

In this paper, we examine how many firms have adopted voluntary restriction policies over the years and whether insiders continue to earn significant abnormal profits from their insider transactions even after the adoption of these restriction policies. While previous studies such as Bettis et al. (2000) document that insiders of firms with restriction policies earned significantly less abnormal profits, it remains unclear whether insiders are still earning abnormal profits from their transactions after their firms' adoption of restriction policies. This is a critical question that needs to be addressed since it determines whether academics should continue to use insider trading as a source of informed transactions in empirical studies, and whether professional investors would be incentivized to revise their active investment strategies based on insider trading. Moreover, the answer to the question would allow regulators and policy makers to evaluate the effectiveness of regulations on insider trading and follow-up enforcements.

Unlike Bettis et al. (2000) who employ a survey approach in examining the profitability of insider trading for firms with self-imposed insider trading restrictions, this study uses an approach that identifies firms with seeming restriction policies based on insiders' trading patterns, which is similar to the approach used in Roulstone (2003), and allows us to use a more comprehensive dataset. While the survey approach allows researchers to identify firms with restrictions without error, it tends to limit the number of sample firms. In comparison, the approach used in this paper is subject to a misclassification problem. To reduce the possibility of reaching a false conclusion arising from misclassification, we check the robustness of the results using an alternative approach that identifies firms with restriction policies by searching for company websites as used in Dai et al. (2013).

Bettis et al.'s (2000) main reason for examining abnormal profits earned by insiders was to check whether market makers would face lower adverse selection costs during blackout periods. Therefore, they only examined short-term (one-week) abnormal profits earned from insider transactions. In this paper, however, we focus on longer investment horizons, namely, three- and six-month horizons. This is because our main question addresses whether insiders continue to earn abnormal profits from their insider transactions even after the adoption of voluntary restriction policies. Additionally, the short-swing rule, under which only those profits earned from round-trip insider transactions over a period longer than 6 months are legitimate, leads us to focus on longer horizons.[7]

In addition, we closely examine whether insiders react to these restrictions in strategic ways in order to continue exploiting their private information through a selective assessment of it. Earlier work by Cheng and Lo (2006), for example, finds that managers strategically choose disclosure policies and time their trading only for purchase transactions but not for sale transactions, possibly to avoid potential legal troubles from taking advantage of negative private information.[8] If the litigation risk is higher following insider sales than insider purchases, insiders would be more cautious in exploiting negative private information while continuing to exploit positive private information.[9]

Finally, we examine how restriction policies are related to the degree of information asymmetry and corporate governance. Since restriction policies significantly limit timely informed trading, it is possible that such policies would negatively affect the stock price informativeness and increase the degree of information asymmetry. Conversely, these policies may encourage other informed

[5] Garfinkel (1997) finds that insider transactions around earnings announcements after the passage of ITSFEA, become less “informed” with respect to the news in the announcement.

[6] Both Jeng (1998) and Bettis et al. (2000) provide evidence that many companies adopt internal policies restricting trading by insiders. Jagolinzer et al. (2011) show that 80% of their 260 sample firms with restriction policies require all insiders' trades to be pre-approved by the general counsel even when those transactions are made during allowed time windows. The mean blackout period is around 46 days prior to and one day after a quarterly earnings announcement.

[7] Section 16(b) of the Securities and Exchange Act of 1934 requires short-term profits earned by insiders of a firm from round-trip transactions made within a 6-month period to be returned to the company.

[8] They point out that insider sales attract more legal troubles than insider purchases since investors who suffer from actual losses from a significant price decrease following insider sales are more likely to allege a violation of the “disclose or abstain” rule than investors who suffer from opportunity losses from a significant price increase following insider purchases are. The “disclose or abstain” rule is based on Cady, Roberts and Co. (40 SEC 907 [1961]) and requires that anyone in possession of material non-public information should either disclose it to the public before trading or abstain from trading. As explained earlier, Bettis et al. (2000) find that insiders of firms with blackout periods earn significantly lower abnormal returns from their sale transactions than those of other firms, but the result does not hold for their purchase transactions. This is also indicative of the possibility that insiders respond to corporate restrictions on insider trading in an asymmetric way to continue to exploit their information advantage without violating restriction rules and increasing their legal risk.

[9] During June 1974 and June 2012, there were 318 articles in The New York Times (NYT) and 31 abstracts in the Wall Street Journal Abstract (WSJ), which include the term, “illegal insider trading” and are available in LexisNexis. A close examination of the articles and abstracts reveals 18 lawsuits and 54 prosecutions in the NYT articles, and seven lawsuits and one prosecution in the WSJ abstracts. Out of the cases reported in NYT, we were able to identify that 11 (five lawsuits and six prosecutions) cases were related to insider sales while 20 (four lawsuits and 16 prosecutions) were related to insider purchases. For other cases, we could not clearly identify the types of illegal insider transactions. We also noticed that most illegal purchases were related to mergers and acquisitions (M&A). Excluding M&A related cases, there were 14 sales related cases and only two purchases related cases, suggesting that for non-M&A related cases, the majority of such cases are related to illegal insider sales. This supports the possibility that insiders perceive a higher litigation risk from informed insider sales than informed insider purchases.