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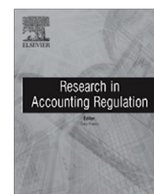

The effect of Sarbanes-Oxley on the timely disclosure of restricted stock trading

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ABSTRACT

Our paper investigates the effect of the Sarbanes-Oxley Act (SOX) on the disclosure timeliness of restricted stock trading. Insiders selling restricted stock are required to file a Form 144 because the stock is restricted and also a Form 4 because they are an insider. We confirm that mandatory filing requirements under Section 403 of SOX reduced the Form 4 disclosure delay for restricted stock transactions from 24 days in the pre-SOX period to the mandated 2 days in the post-SOX period. Although SOX did not mandate changes to Form 144 filings, we expect that disclosure timeliness of Form 144 filings is likely impacted by SOX. We find that Form 144 filings of restricted stock sales have become less timely. In the post-SOX period, Form 144, the *intent to sell restricted stock*, is almost always reported *after* the Form 4 disclosure of the executed trade. Thus, an unintended consequence of SOX is that by making the Form 4 filing more timely than the Form 144, market participants will know about a trade sooner, but have less information about the type of equity traded. An implication of this finding is that Section 403 of SOX may not have unambiguously improved investor protection as intended.

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Introduction

The objective of the Sarbanes-Oxley Act of 2002 (SOX) was "to protect investors by improving the accuracy and reliability of corporate disclosures made pursuant to the securities laws, and for other purposes." Section 403 of SOX mandated a significant increase in the timeliness of corporate disclosures of stock transactions by insiders (officers, directors or beneficial owners who own at least 10% of a company).[1] Section 403 requires corporate insiders to report to the Securities and Exchange Commission (SEC) any transactions in their firm's equity securities within two business days of the transaction (Form 4). Further, the Form 4 filing must be filed electronically and disclosed on a company's corporate website within one business day of the SEC filing. Accelerating the filing is consistent with increasing investor protections as prior research suggests that market participants benefit from knowledge of insider transactions. These disclosures can help investors assess the likelihood that insiders' trading is based on private information motives rather than liquidity needs and allow investors to take appropriate actions to limit potential losses.[2]

Insiders selling restricted stock are subject to dual reporting requirements – they are required to file Form 144 (because the stock is restricted) and Form 4 (because they are insiders).

Section 403 greatly improved the transparency of executed trades by insiders on Form 4, but did not mandate

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[1] Numerous studies research the effectiveness of the various mandates of SOX. See Moehrle, Farmer, Reynolds-Moehrle, and Stuerke (2011); Jonas, Moehrle, and Reynolds-Moehrle (2010) for summaries of SOX research.

[2] Information theory says that less informed traders lose in trades with more informed traders (Kyle, 1985).

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changes to reporting requirements of restricted stock sales (Rule 144). Despite not explicitly addressing it, it is unlikely that the timeliness of Form 144 filings was unaffected by SOX. Section 403's singular focus on timely Form 4 reporting may have resulted in a decrease in regulatory compliance and timeliness of Form 144 filings. Alternately, increased regulatory scrutiny under SOX, may result in increased timeliness of Form 144 filings. We investigate this open empirical question in this paper.

The paper proceeds as follows. We first provide a discussion of the reporting requirements for insider trading of restricted stock before and after SOX. Next, we provide details of the nature of restricted stock and requirements under Rule 144. We follow with our hypothesis development, sample selection, and empirical results. The final section of the paper provides conclusions and implications of our research.

Background on reporting requirements of insider trades

Prior to the passage of SOX, under Section 16(a) of The Securities Exchange Act of 1934, insiders who transact were required to file Form 4, "Statement of Changes of Beneficial Ownership of Securities," with the SEC within 10 days after the close of the month in which the trade occurred. Therefore, a timely Form 4 may have been filed as many as 40 days subsequent to an insider's stock trade. This provided insiders with the discretion to file their Form 4 anytime between the trade-date and the SEC imposed deadline. Thus, insiders could choose to delay filing until the deadline, or they could voluntarily disclose the trade promptly and file Form 4 immediately following their trade. Franzen, Li, Vargus, and Urcan (2012) analyze a sample of firms where insider's choose between selling restricted or unrestricted company stock. They find that managers delay the reporting of the completed trade; the average time interval between insiders' Form 144 and Form 4 disclosures averaged 26 days in the pre-SOX time period.[3]

In 2002, SOX increased the timeliness of Form 4 filings, as Section 403 of the Act requires electronic filings of Form 4 within 2 days of the transaction, thus effectively eliminating reporting delays. The primary stated objective of Section 403 of SOX was to reduce the delay in the public disclosure of insider trades. Consistent with this goal, Brochet (2010) and Franzen et al. (2012) document that the number of days between the transaction date and the Form 4 filing is significantly lower in the post-SOX time period.[4] One implication of the change was it likely reduced insider trading incentives as prior research indicates that the insider trading disclosure regime can influence the extent to which managers opportunistically trade (Cheng, Nagar, & Rajan, 2007; Etebari, Tourani-Rad, & Gilbert, 2004; Grossman & Stiglitz, 1980; Huddart, Hughes, & Levine, 2001; Mendelson & Tunca, 2004). Further, heightened scrutiny of trades may increase insiders' perceived legal jeopardy and limit their ability to profit from informative trades. Consistent with this, Brochet (2010) finds evidence that insiders are less likely to sell ahead of privately held bad news in the post-SOX period.

Corporate insiders can transact in many different types of their firm's equity, e.g., restricted stock, unrestricted stock, warrants, and derivatives such as stock options, each with unique disclosure requirements.[5] Following SOX, the SEC requires that insiders report virtually all of their equity related transactions on Form 4.[6] Further, some transactions may require additional supplemental disclosures, especially unregistered securities that are being sold pursuant to a regulatory exemption. Specifically, *restricted* stock transactions generally require additional investor, firm, and equity related information be reported on or before the transaction date in a Form 144. Thus, insiders selling restricted stock are subject to dual reporting requirements – they are required to file Form 144 (because the stock is restricted) and Form 4 (because they are insiders). In contrast to Form 4 filings pre-SOX, Form 144 filings could not be delayed. Transactions must be filed with the SEC on Form 144 prior to or concurrently with the date of sale. SOX did not change the filing regime for restricted stock trades reportable on Form 144.

Restricted stock and Rule 144

Restricted stock is created when firms issue equity securities that are not registered with the Securities and Exchange Commission. Restricted stock is most often issued: (1) for private equity investments, (2) as a form of payment in mergers and acquisition transactions, (3) as a component of stock benefit plans, and (4) for services rendered in lieu of monetary compensation. Restricted securities cannot be sold to the public unless the firm subsequently registers the securities with the SEC or the seller meets the requirements necessary to claim that the securities are exempt from registration. The most common exemption used by individual investors is Rule 144, which creates a safe harbor for restricted stock sales.

In order to invoke the safe harbor provisions under Rule 144 each of the following criteria must be met:

(1) The seller must own the security for at least one year.[7]

[3] The delayed reporting environment could lead managers to strategically choose one type of equity over another. Franzen et al. (2012) find that the market response to insiders' sales of unrestricted stock is significantly more negative than for that for restricted stock sales in the Pre-SOX period. In the post-SOX time period the return relationship reverses and the magnitude of the returns is approximately one-tenth of the pre-SOX period.

[4] Prior research also provides evidence of increased disclosure timeliness following SOX for other filing types. Karim and Pinsker (2011) provide evidence that 8-K disclosure timeliness increased following SOX.

[5] To distinguish them from restricted securities, we refer to equity securities that are registered as "unrestricted" in that there are no SEC imposed restrictions on their sale.

[6] Prior to SOX, a small subset of transactions, including certain transactions between insiders and the firm were eligible for deferred reporting, whereby these events were reported on Form 5 at year-end. Following SOX, these transactions were required to be reported on Form 4, and the nearly all delayed reporting was eliminated.

[7] Prior to February 1997, the holding period was 2 years for affiliates. Effective on February 15, 2008 the holding period was shortened to 6 months for affiliates of reporting companies. The holding period begins upon the date of acquisition, defined as the date when the entire purchase price has been paid, or the services rendered.

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