



Private information leakages and informed trading returns of tech target firms



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ABSTRACT

We measure private information leakages about target tech firms in mergers. We find that tech target firms with a higher level of asymmetric information are more exposed to mispricing, which allows for larger stock price gains from using expert networks or other means to obtain private information about impending mergers. We also find that the level of information leakages is reduced since the Sarbanes–Oxley Act and Galleon case. However, the reduction in the information leakage prior to tech merger announcements has been offset by the increased share price responses of tech firms to the merger announcements. Therefore, the potential rewards from using expert networks or other means to retrieve private information about tech target firms are still substantial for informed traders.

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1. Introduction

Social networking has taken on a new meaning in the tech sector. With the high degree of asymmetric information surrounding tech firms, institutional investors are relying more heavily on expert networks for private information. Tech firms face a vicious cycle of seeking continual investment to support innovation, which drives their growth. They cannot rely on a narrow product line like some manufacturing firms. Because they must hide their innovations in progress from their competitors, their public disclosure of the research and development is very limited. Consequently, they exhibit a high degree of asymmetric information, which causes uncertainty about their true valuation. A single piece of technology can have a major impact on a tech firm's valuation, and investors have an incentive to obtain the private information about tech firms that other investors do not have.

Before 2000, tech firms commonly accommodated their favored analysts and investors by providing private information.¹ This was explicitly outlawed by Regulation FD, which was implemented on October 23rd, 2000. Analysts still attempt to obtain private information about tech firms, but have to work harder at obtaining it. In an article on inside information in the tech sector, a tech analyst states “there's just a huge amount of invested dollars focused on tech, and financial analysts chase each other for who has the best information.”²

Hedge funds have grown over time, and many of them invest in technology firms. They seek alternative sources of private information (see “Unintended consequence of Reg. FD” by Zuckerman & Pulliam, 2010). The growth and competition for material information has resulted in the development of expert networks.³ In 2006, there were about 30 expert networks that had annual revenues exceeding \$300 million. By 2009, there were more than 45 expert networks with annual revenues exceeding \$400 million.⁴ The connection between the experts and the investors has facilitated by the development and growth of expert network firms. For example, the Gerson Lehrman Group has about 200,000 experts. The expert networks are especially popular in

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¹ See http://www.cbsnews.com/8301-505125_162-28243043/is-insider-trading-still-rampant-on-wall-street

² See <http://www.reuters.com/article/2010/12/17/us-insidertrading-culture-idUSTRE6BF5WP20101217>

³ See <http://www.americancriminalawreview.com/Drupal/blogs/blog-entry/expert-networks-crossing-insider-trading-line-10-03-2011>

⁴ See <http://www.insideinvestorrelations.com/articles/sell-side/15351/rise-expert-networks>

the tech sector, as retired executives and existing employees of tech firms are paid large compensation to provide information to hedge funds, venture capitalists, and other investors. The investors commonly want information about a firm's supply chain, product innovations, and large purchase orders, which could indicate future movements in earnings. Experts can provide information that offers valuable insight about a firm or industry without violating Regulation FD. However, some investors that pursue expert networks are in search of material non-public information.⁵ This may explain why some individual experts have been paid \$150 to \$1000 per hour, or more than \$100,000 over time to participate in phone calls with clients.⁶ A McKinsey consultant was paid \$500,000 per year by the Galleon hedge fund for several years to provide his knowledge.

Many of the insider trading charges by the Securities and Exchange Commission (SEC) cite expert network participants. MarketWatch reported that regulators were putting a "spotlight on a trend of so-called expert networks." It quoted John Coffee, a Columbia Law School professor: "The expert network says there shall be no exchange of information, but why is the hedge fund paying \$30,000 to \$40,000 to meet these people."⁷

Tech firms are more susceptible to insider trading because there are more corporate transactions, there is more focus on mergers, and there is more focus on earnings announcements.⁸ Since these types of events can have a major impact on share prices of tech firms, investors who possess the information in advance can generate large trading returns. In one of the most publicized cases, the SEC alleged on November 20, 2012 that hedge funds or their investment advisors achieved profits or avoided losses totaling \$276 million from trading ahead of news in July 2008 about an Alzheimer's drug. A doctor who was the chairman of a safety monitoring committee that was overseeing the clinical trial was also paid more than \$1000 per hour for his expertise in an expert network. He received about \$108,000 for his consultations with investors.⁹

In some cases, investors hiring the experts have indicated that the phone calls will not be recorded, which could be intended to encourage experts to divulge inside information.¹⁰ The establishment and growth of expert networks have resulted in concerns as summarized in a CBS news article: "As long as there's a stock market, there will be investment professionals looking for a competitive edge and a percentage of those willing to cross the line."¹¹

Stock price movements prior to public announcements can reveal the level of private information, and mergers are especially appealing to informed investors, because publicly traded target firms tend to experience a very large jump in their stock price when they a merger bid is announced. Some studies, including those by Keown and Pinkerton (1981), Jarrell and Poulsen (1989), Schwert (1996), and Chira and Madura (forthcoming) have measured the degree of information leakages experienced by public targets based in the U.S. prior to merger bid announcements in order to offer inferences about insider trading. However, no study to our knowledge has attempted to measure the effects on tech firms that are subject to takeover bids, or to explain why the level of information leakage may be higher for some types of tech target firms than others. Yet, when investigating insider trading, tech target firms deserve special attention because of the established expert networks within the technology sector. Our objective is to investigate the private information surrounding tech firms that reaches investors.

We focus on merger announcements involving publicly-traded tech targets, so that we can measure the level of private information revealed about the tech targets before the announcements. A negative stock price runup prior to a merger announcement implies less than zero private information and could be misleading. We therefore apply a transformation to any tech targets that experience a negative runup prior to their merger announcement. We also apply an alternative method in which we delete these targets from our sample.

Our analysis shows much variation in the level of private information among tech targets. In fact, more than one-third of the tech targets experience a negative runup. When excluding these firms, the mean level of private information prior to merger announcements is substantial, along with potential trading returns for investors who trade on that information.

We apply a multivariate analysis to explain the variation in the level of private information and trading returns among tech firms. In general, tech firms that have less investment in research and development, larger capital expenditures and more risk are subject to higher levels of private information leakage. These firms may be subject to more asymmetric information and more mispricing, which allows for larger stock price gains from using expert networks or other means to obtain private information about the impending mergers. In addition, tech target firms with higher trading volume experience higher levels of private information leakage, as informed traders (which we define as traders using private information) may be able to more easily hide their trades of those targets' shares.

Our multivariate analysis also confirms a reduction in private information leakage following the Sarbanes–Oxley Act and the Galleon case while accounting for other characteristics. However, the returns earned by informed traders from trading on private information are not reduced since these government initiatives. In essence, the reduction in leakage of private information has been offset by higher share price responses of tech targets to merger announcements after the Sarbanes–Oxley Act and Galleon case. Consequently, informed traders are still able to extract large profits from illegally capitalizing on private information, although the risk of prosecution and criminal or civil penalties from such trading is now higher.

⁵ See <http://www.edn.com/electronics-news/4369622/Insider-trading-sting-reverberates-throughout-the-tech-industry>

⁶ See <http://dealbook.nytimes.com/2010/12/16/four-arrested-in-insider-trading-investigation/>

⁷ See <http://www.marketwatch.com/story/expert-networks-key-to-sec-insider-trading-cases-2012-11-21>

⁸ See <http://www.bloomberg.com/news/2011-04-07/raissi-says-tech-industry-more-prone-to-insider-trading-video.html>

⁹ See <http://online.wsj.com/article/SB10001424127887323713104578130930796204500.html>.

¹⁰ See <http://www.integrity-research.com/cms/2011/02/07/sec-files-charges-in-insider-trading-probe/>

¹¹ See http://www.cbsnews.com/8301-505125_162-28243043/is-insider-trading-still-rampant-on-wall-street/

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