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Commitment to social good and insider trading ☆

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ABSTRACT

A firm's investment in corporate social responsibility (CSR) builds a positive image of caring for social good and imposes additional costs on executives' informed trading, which is widely perceived self-serving. We thus expect executives of CSR-conscious firms to be more likely to refrain from informed trading. We find that executives of CSR-conscious firms profit significantly less from insider trades and are less likely to trade prior to future news than executives of non-CSR-conscious firms. The negative association between CSR and insider trading profits is more pronounced when executives' personal interests are more aligned with the interests of the firm.

1. Introduction

Corporate social responsibility (CSR) has received growing attention from regulators, corporate executives, investors, and various other stakeholders in recent years. In this study, we examine the association between these increasingly important corporate activities of committing to social good and executive insider trading, an action commonly perceived as self-serving.

Managers trading on material private information likely incur higher costs when their firms make larger CSR investments. A firm's commitment to social good helps build a positive image of caring for the society and refraining from corporate greed (Fombrun and Shanley, 1990; McWilliams et al., 2006). While this image benefits the firm in various ways (Fombrun, 1996), it imposes additional costs on managers engaging in activities—in particular, informed trading—that conflict with the appearance of doing social good. Informed trading is prohibited by law and often considered greedy and unfair expropriation of uninformed investors (e.g., Will, 1987). When informed trading is detected, the negative publicity

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likely impairs the firm's positive image and reduces the associated benefits, eventually causing damage to managers' personal interests that are tied to the image of the firm. We thus expect a firm's socially responsible image to constrain profitable insider trading, consistent with reputation being an informal enforcement mechanism against opportunism as predicted in the economic literature (e.g., Klein and Leffler, 1981). In addition, when a firm commits to social good, it often cultivates a corporate culture of "do no evil" (Hoi et al., 2013). Such a culture imposes higher internal costs on executives if they deviate from that norm.

A firm's CSR engagement can also be negatively associated with insider trading if both corporate CSR policies and executives' insider trading reveal heterogeneity in managers' individual degrees of altruism and greed recognized in the economic literature (e.g., Benabou and Tirole, 2006). While standard neoclassical and agency theories allow for a limited role through which individuals can exert idiosyncratic influence on corporate policies, Bertrand and Schoar (2003) propose that extensions of these models allow differences in personal styles to cause heterogeneity in corporate practices. This view suggests that a firm's CSR orientation can be a manifestation of executives' personal differences in the tendency to be a good citizen. CSR-conscious executives are therefore more likely to refrain from self-serving actions such as informed trading.

While the above explanations predict a negative association between CSR and informed trading, some management research suggests the opposite. Godfrey et al. (2009) and Minor and Morgan (2012) argue that CSR engagements provide a form of insurance against fallout from negative events. This suggests that executives of CSR-conscious firms would incur lower expected losses from informed trading, thereby a potentially positive association between CSR and informed trading.

We measure a firm's commitment to social good by examining the social ratings data issued by MSCI ESG STATS (MSCI hereafter; previously known as KLD) from 1991 to 2010. Similar to the literature (e.g., Hong and Kostovetsky, 2012; Kim et al., 2012), we assess a firm's CSR performance with a summary CSR score that reflects various aspects of social responsibility. A firm is classified CSR-conscious if it has more CSR strengths than concerns. Following the literature on insider trading (e.g., Huddart and Ke, 2007; Jagolinzer et al., 2011), we measure executives' insider trading profits as potential profits gained from purchases or potential losses avoided from sales.

Consistent with the prior literature (e.g., Aboody and Lev, 2000; Huddart and Ke, 2007; Jagolinzer et al., 2011), we find that on average executives profit from purchases but not from sales, and therefore we focus on insider purchases only. While executives of CSR-conscious firms still profit from insider purchases, their profits are significantly lower than those made by executives of non-CSR-conscious firms. The difference in trading profits persists after we control for proxies of information asymmetry, insider trading restrictions, and contrarian trading tendencies. The inference remains robust when we use propensity-score matching to alleviate endogeneity concerns. Further analyses of changes in CSR orientation suggest that executives make lower (higher) trading profits as a firm becomes CSR conscious (non-CSR conscious). The negative association between CSR and executives' insider trading profits is consistent with both CSR constraining (although not eliminating) informed trading and individual heterogeneity explaining both CSR and insider trading. It is inconsistent with CSR acting as insurance against the adverse effects of informed trading.

A potential concern of measuring insider trading profits with post-trade price movements is that these movements may in part reflect the market's perception of the trades themselves, not necessarily insiders' superior information (e.g., Ravina and Sapienza, 2010). To address this issue, we examine whether executives trade on future news as an alternative measure of insider trading, following Piotroski and Roulstone (2008). We find that the likelihood of executives of non-CSR-conscious firms purchasing shares increases with future earnings changes and stock returns, suggesting that these executives trade on future corporate news. In contrast, we do not find evidence of executives of CSR-conscious firms trading on future earnings or return performance. Examining propensity-score-matched CSR-conscious and non-CSR-conscious firms yields the same inference—executives of CSR-conscious firms are less likely to trade on future corporate news. An analysis of changes in CSR orientation also indicates that executives trade on future corporate news before a firm becomes CSR conscious, but not afterwards, and after a firm ceases to be CSR conscious, but not beforehand. Taken together, these findings lend support to our interpretation of the trading profit analyses and results.

With the above analyses suggesting a negative association between CSR and informed trading, we next explore channels through which damage to a firm's CSR image translates into personal costs for executives and thus discourages informed trading. First, executives gain personal reputational capital from corporate activities (e.g., Fama, 1980; Brickley et al., 1999). If executives are vocal (or visible) with regard to the firm's CSR activities, their personal reputation is more closely tied to the firm's CSR reputation. We thus expect the firm's CSR orientation to have a stronger constraining effect on these executives' trading. In addition, if being vocal about CSR reveals that these executives are more altruistic or less greedy, we would also expect them to refrain more from informed trading. We determine whether executives are vocal about CSR via a comprehensive search of the internet, news media, press releases, and CSR reports. Consistent with our expectation, we find the constraining effect of CSR on insider trading profits to be stronger for CSR advocates.

Second, damage to the CSR image of the firm can hurt executives through their stock ownership. We expect the constraining effects of CSR to be more pronounced when executives' wealth is more closely tied to firm value. Consistent with this expectation, we find that the negative association between CSR and executives' insider trading profits is stronger when they hold more company shares. This result is more likely explained by the constraining effects of CSR than individual heterogeneity, since executives with higher stock ownership are not necessarily more altruistic or less greedy.