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The effect of voluntary versus mandatory adoption of trading policies on the returns to insider trades

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ABSTRACT

An insider trading policy is a critical aspect of a firm's internal governance which ensures the maintenance of corporate transparency. We examine the effect of trading policies on the returns to trades by corporate insiders over two periods: one where the adoption of a policy is voluntary and another where it is mandatory. In the former, we find that the requirement to notify the firm prior to trading does not result in lower trade returns on days outside the permitted trading windows. Where adoption of a policy is mandatory, trade returns made during the restricted windows are higher and the requirement to notify prior to trading significantly reduces these returns. The mandatory disclosure of a trading policy is effective in reducing returns from insider trading, suggesting improved investor confidence through greater transparency.

1. Introduction

A firm's insider trading policy is an integral part of the overall firm governance system describing how a company is directed and managed such that objectives are met, risks are monitored and performance maximised. The role of a trading policy within the governance framework is to ensure and promote ethical and responsible decision making by insiders so that investor confidence is preserved and investor protection maintained. Furthermore, it provides transparency around policies surrounding insider activities, in particular restrictions on trading. If insider trading is viewed as an agency cost because private benefits can be extracted at the expense of other shareholders (Bebchuk and Fried, 2003), an effective governance system can be expected to reduce this cost by active monitoring of insiders' trading activities (Bettis et al., 2000).

Self-imposed trading policies work in conjunction with existing country level insider trading regulation which is enforced by market regulators. Lee et al. (2014) find that firm-imposed voluntary restrictions on insider trading activities are effective in reducing the exploitation of private benefits. In this study, we apply a micro approach to investigate the effect of investor protection

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(under the umbrella of corporate governance) on rent extraction via insider trading. Investor protection is proxied by a firm's trading policy under two regimes, of mandatory and voluntary disclosure. We examine how a firm-imposed trading policy affects the returns to insider trades, when the trades are conducted in periods demarcated as "blackout periods" or "permitted periods" in both voluntary and mandatory disclosure environments. In the accounting and finance literature and in regulation, disclosure has been assumed to be a device which reduces information asymmetry, leading to less potential for opportunism. The regulation around the timely disclosure of insider trades is one example of this assumption. Huddart et al. (2007) and Huddart et al. (2001) also provide theoretical support by showing that prompt disclosure of insider trades reduces returns associated with them.

Mandatory disclosure of trading policies is expected to result in a better information environment (Huddart et al., 2001). However, in their investigation of Rule 10b5-1 trading plans in the US, Henderson et al. (2014) show that voluntary disclosure increases insider trading returns due to the legal cover provided by the disclosure. That is, voluntary disclosure generated protection for opportunistic trading. The same could apply with mandatory disclosure of trading policies where insiders trade opportunistically for higher returns and escape scrutiny because of a disclosed and restrictive trading policy. We exploit this tension in the literature on mandatory disclosure of insider trading policies.

Prior studies, including Anand and Beny (2007); Gompers et al. (2003) and Cremers and Nair (2005), show the effects of good corporate governance on firm value. Directly relevant to this study are the findings that strong corporate governance reduces returns from insider trading (Chang et al., 2005; Fidrmuc et al., 2006; Jagolinzer et al., 2011; Ravina and Sapienza, 2010). Fidrmuc et al. (2006) use block monitoring to proxy for governance, Chang et al. (2005) use aspects of the board, Ravina and Sapienza (2010) employ Gompers et al.'s (2003) Governance Index and Jagolinzer et al. (2011) apply the general counsel's approval. In contrast, using shareholder protection, Fidrmuc et al. (2013) find a positive correlation between country level shareholder protection and post insider trade abnormal returns, arguing that their results support the information content hypothesis.

One contribution of our study to the existing literature is the investigation across two distinct years: the calendar year 2007 when disclosure of a trading policy was voluntary, though recommended, and 2013 when it was mandatory.[1] It is expected that the requirement to disclose a trading policy alters the trading habits of insiders and the resultant returns to their trades. For example, Brochet (2010) compares the information content of insider trades before and after the Sarbanes-Oxley Act 2002 (SOX) where SOX required the reporting of trades within two business days and greater scrutiny of insider activities. Post SOX, insider purchase filings are accompanied by higher abnormal returns and trading volume while for insider sales, the returns are lower. Jagolinzer et al. (2011) examine the role of the general counsel who was responsible for enforcing corporate governance within a firm. Trades requiring general counsel approval have lower returns and are less informative about future firm operations.

Our study also differs from prior work as we consider a range of items in the firm's insider trading policy. Monitoring of trading activities is conducted via items within the policy such as timing restrictions on trades and notification prior to trading. In contrast to studies that have studied the influence of certain aspects of trading policy (see for example, Bettis et al., 2000; Hillier and Marshall, 2002; Jagolinzer et al., 2011), we construct proxies that allows us to consider the combined effect of trading policy items on the information environment. We deliberate how these trading policy items influence the firm's information environment by estimating trade returns.

The composition of reported insider trades differs between countries due to the various definitions of insider: that is, parties who are required to report changes in their shareholding. In the U.S., corporate insiders are defined as company officers, directors and any beneficial owners of more than ten percent of a class of the company's equity securities (equivalent to substantial shareholders in Australia) while in Australia, the definition is restricted to company directors, being the parties who are required to disclose under s205G of the Corporations Act (2001). This important difference means that insider trades examined in Australia do not include those by large shareholders which may have different motivations for trading. Another important difference between the Australian and US institutional setting is the absence of the "short swing" rule (i.e., Section 16(b) of the Securities and Exchange Act of 1934) where insiders are penalised for profits earned on trades made fewer than 180 days after prior trades. Because of this, the use of a more prescriptive insider trading policy may signal greater emphasis placed by the firm on corporate governance and monitoring.

Our results indicate that the number of items prescribed in firm trading policy has increased over the two periods examined. Only 7% of the firms in our 2013 sample did not have a restricted trading window, compared to 52% in 2007. On average, a firm's trading policy covers four of the nine categories identified in 2007 and contains just over six categories in 2013. We also find in firms with greater analyst following and active trading by insiders, policies that are more specific (i.e., have more categories), suggesting they were developed to instil investor confidence and/or to monitor trading activity.

We find returns to insiders are higher when they trade in the restricted trading windows, inferring that insiders profit from information that they are privy to during those times. Within firms that impose blackout periods, the returns to insiders are

[1] The Australian Securities Exchange Corporate Governance Council (ASXCGC) released its Principles of Good Corporate Governance and Best Practice Recommendations which included ten core principles and guidance on implementation in the form of best practice recommendations. Firms were required to disclose in the annual report the extent to which the best practice recommendations were observed and, if recommendations were not adhered to, the reasons for not doing so. Principle 3 of the Recommendations is relevant to trading policies and this study because it discusses the need for integrity among those who influence company strategy and financial performance. It also actively promotes ethical and responsible decision making. In particular, Recommendation 3.2 refers to the establishment of a policy concerning trading in company securities by directors, senior executives and employees and the disclosure of such a policy.