Insiders Beat Market Before Event Disclosure: Study

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By Liz Hoffman
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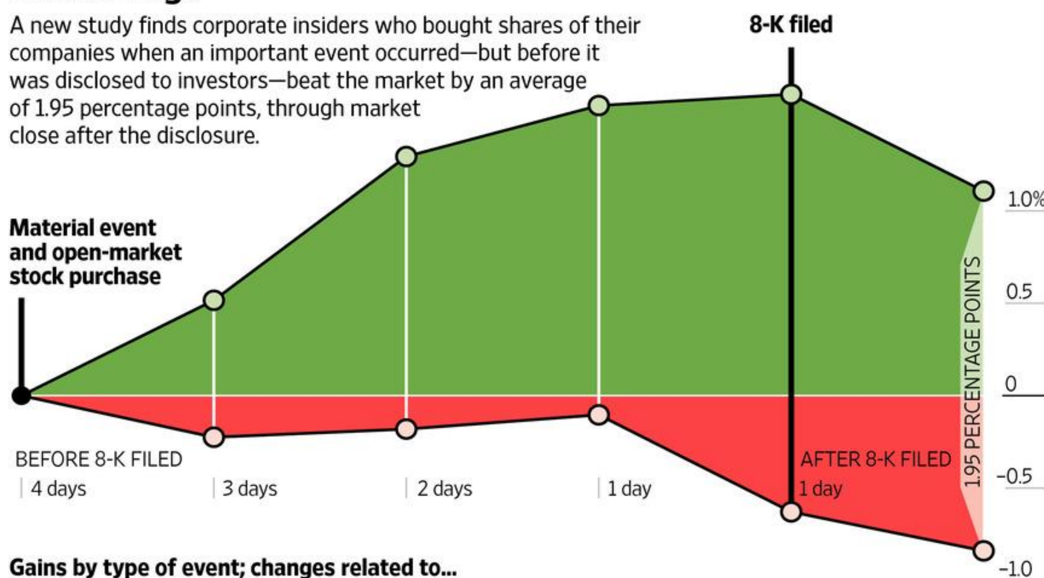
Researchers from Columbia, Harvard find small but persistent edge



Corporate executives and board members regularly make market-beating returns from buying and selling their companies' stock in the days before disclosing a significant event, according to a study that says it has found a link between insider knowledge and investment profits.

Researchers at Columbia and Harvard universities analyzed 42,820 insider purchases and sales reported by companies between 2004 and 2014. All occurred within the four business days the Securities and Exchange Commission gives companies to disclose major developments.

While few scored the eye-popping returns that often attract the attention of regulators, the researchers found that they notched a small but persistent edge. On average, the officials netted about 0.4 percentage point over a broad market index between the time of their trades and the

market close after the disclosure. These gains, realized over the span of a few days, would be much larger on an annualized basis.

When officials bought shares outright—rather than by exercising options received as compensation—the gains were even better, at about 1.6 percentage points over the index. Open-market purchases are noteworthy because corporate executives, who typically receive chunks of stock through salaries and bonuses, are often less inclined to buy shares out of pocket.

The longer companies waited to make disclosures, the better the returns, according to the study. When companies used the full four-business-day window, the average excess profit rose to 1.95 percentage points.

Securities laws require companies to disclose major developments on SEC forms known as 8-Ks, which cover everything from new credit agreements to acquisitions and dividend announcements. Insiders aren't explicitly banned from trading ahead of these announcements but, as with other times, can't do so if they possess market-moving information unknown to other investors. What constitutes such information is a matter of debate in some cases.

The findings wade into a long-running debate over whether U.S. securities laws, many of them decades old, can effectively police a trading market that has grown ever faster and more complex. Critics say the lag time allowed by current disclosure rules is a relic of an era before electronic filings and is ripe for abuse.

"To leave open a gap like that is an invitation to insider trading," said Robert Jackson, a Columbia Law School professor who co-wrote the study with his colleague Joshua Mitts and Alma Cohen of Harvard.

It isn't clear that the officials, particularly less-senior ones, were aware of the developments disclosed or knew which direction they were likely to move the stock. In some cases, the information may have been made public before the 8-K, by other means. But the consistency of the profits suggests insiders benefit from proprietary knowledge of their businesses when making trades, Mr. Jackson said.

The study adds to a body of academic and other work that has made similar findings. A Wall Street Journal investigation in 2012 found that many executives reaped robust gains when executives beat the market when they traded ahead of major announcements.

The latest study excluded any filings that noted the trades in question were made pursuant to so-called 10b5-1 plans. They are pre-established arrangements under which executives can schedule trades for particular times or price triggers. Executives don't have to disclose these plans but often do so on their trading forms, which can serve as a strong defense against any allegations of impropriety.

Wausau Paper Corp. on Aug. 13, 2014, finalized the sale of a long-shuttered Minnesota plant that had proved difficult to unload. On Aug. 18, Chairman and Chief ExecutiveMichael Burandt bought 3,000 shares of Wausau stock, his first stock ownership since taking the job four months earlier. After the sale was disclosed to investors on Aug. 19, the shares rose and Mr.

Burandt earned a paper profit that beat the market index by two percentage points, the study found. A Wausau spokesman said Mr. Burandt believed the shares, which had fallen sharply in the prior months, were undervalued. He added that Wausau executives had just been allowed to resume trading after being barred from doing so around the company's second-quarter earnings.

In another example, Simmons First National Corp., a small Arkansas bank, moved in August 2012 to buy back $10 million in trust-preferred securities, lowering its overall debt. Then-CEO Thomas May bought 3,000 shares in between when Simmons notified the trustee of its plan and when it disclosed the news. The study's authors calculate an excess return of 1.1% over two days.

A Simmons spokesman declined to comment. Mr. May, who retired in 2013, didn't respond to a request for comment.

Rep. Carolyn Maloney, D., N.Y.., who sits on the House Financial Services Committee and reviewed the latest study's findings, called them "troubling" and said she was preparing legislation to address the issue. Her office is considering several options, including a bill preventing executives from trading their own company's shares ahead of an 8-K filing.

The SEC in 2002 proposed shortening the 8-K filing window to two business days from between five and 15 but backed off amid resistance from corporate law firms, among others, who said it would burden companies, especially smaller ones with fewer resources, and lead to rushed, inaccurate disclosures. The agency settled on four days.

"Companies often need, and do use, that time to make sure the information is accurate," said Bradley Bondi, a lawyer at Cahill Gordon & Reindel LLP who was previously an SEC enforcement official. Shortening the window could lead to errors or sloppily worded filings that could invite shareholder lawsuits, he said: "The main consumer of 8-Ks isn't the investing public—it is the plaintiffs bar."

He said an alternative may be tougher enforcement of laws already on the books. "This isn't a problem with the law," he said.