Corporate insiders disguise share sales with cautious approach to deter predatory short sellers

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Company directors, officers or major shareholders, worried that their personal share sales might trigger aggressive short selling from investors tracking their moves, are disguising their trades with a cautious, incremental approach often spread over several days, new research from the University of Bath shows.

The study from the School of Management confirmed concerns that corporate insiders are managing their share trade sizes and timing with an eye to putting predatory short sellers off the scent. It found that regulators need to be conscious of these cautious trading strategies when trying to identify illegal insider trading.

Equally, short sellers may profit more by identifying these cautious trading strategies rather than simply responding to aggressive one-off sales by corporate insiders. In short selling, an investor who believes a stock will fall can borrow it and sell it on the open market, and then buy it back for less money later to make a profit.

"Corporate insiders are legally permitted to buy and sell shares of the firm and any subsidiaries that employ them once their transactions are not utilizing non-public material information," said Dr. Hanwen Sun of the School of Management.

"Nevertheless, it is difficult to decipher the trading activity of corporate insiders, who are widely believed to have an information advantage over other shareholders or stock market players. However, they are increasingly facing challenges from sophisticated investors such as short sellers who employ an 'order flow trading strategy," which essentially piggybacks on the insiders' advantage and reduces the insiders' potential profits," she said.

Sun said there was growing evidence that short sellers are learning from insiders' order flows and trading accordingly. This trend was forcing insiders to develop a more strategic approach to stay profitable, spreading their share sales over several days rather than in one large package on a single day.

"Our model predicts that insiders tend to adopt a cautious trading strategy—splitting their trades over time and reducing initial sales—when they expect short sellers are using order flows to predict trading patterns. Their aim is to disguise those order flows and frustrate those market players," she said.

Sun said the research suggested the incremental share sales by company directors, officers or major shareholders may reflect private information that is not yet revealed in price. "Cautious selling over several days may help to hide trading that is informed by insider knowledge," she said.

Sun said the empirical evidence and findings were built using the record of all corporate insider sales logged from 2010 to 2019 on Thomson Reuters, along with daily short volumes from the U.S. Financial Industry Regulatory Authority (FINRA), a private corporation that acts as a self-regulatory organization for member brokerage firms and exchange markets. The research found 84% of insider trading strategies were 'aggressive'—sales carried out in one day, while the remainder were 'cautious'—sales carried out in consecutive days.

The study also examined EDGAR search volume right after insider filings. EDGAR, the Electronic Data Gathering, Analysis, and Retrieval system, performs the automated collection, validation, indexing, acceptance, and forwarding of submissions by companies and others who are required by law to file forms with the U.S. Securities and Exchange Commission (SEC).

The SEC EDGAR server maintains log files for all web visits and each log file provides the IP (internet protocol) address of the inquiry. It found that, on average, cautious strategies received 1.20 more IP visits on the first two days since insider filing, and that such excessive IP visits were associated with strong short volumes in the next five days after the IP visits.

"These results help us further support our conjecture that short sellers actively exploit trading opportunities from insider sales," Sun said.

More information: Dingwei Gu et al, Strategic insider trading: Disguising order flows to escape trading competition, *Journal of Corporate Finance* (2021). DOI: 10.1016/j.jcorpfin.2021.101891

Provided by University of Bath

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