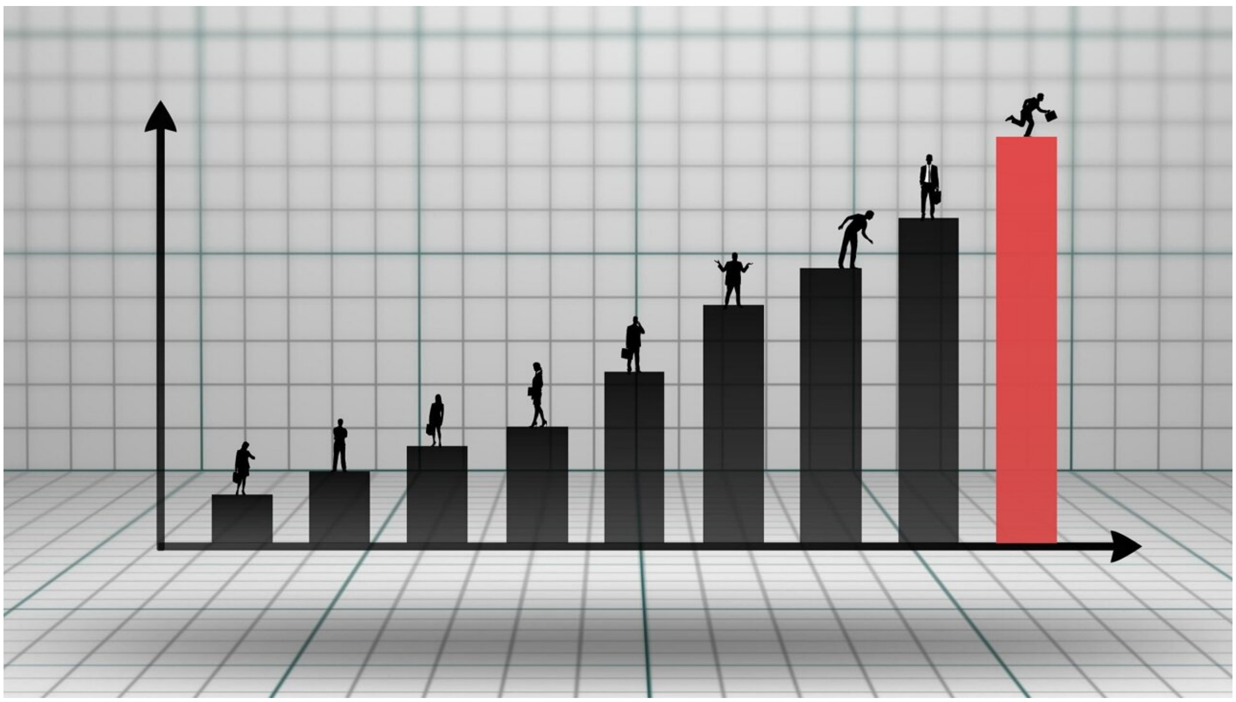
Insider trades on behalf of family are more lucrative than other trades, study finds

December 8 2022, by Jon Niccum



Credit: Pixabay/CC0 Public Domain

When people hear the term "insider trading," they typically think of financial scandals involving Martha Stewart, Ivan Boesky or the movie "Wall Street." But the term also has far less sinister connotations.

"Insiders trade in shares of their firms all the time," said Jide Wintoki, Capitol Federal Professor of Finance and associate dean of graduate programs at the University of Kansas School of Business.

"But we identify a unique group of these trades made on behalf of other people who the insider may be connected to. It's not in their own account; it's on behalf of others. The evidence we present suggests these tend to be even more informed than the other insider trades."

His article, titled "Indirect Insider Trading," compares the information content of direct insider trades made in a personal account versus indirect ones made in the accounts of family members, trusts, retirement accounts and foundations. The research determines these trades contain more predictive information about earnings surprises and large price changes. It appears in the Journal of Financial and Quantitative Analysis.

A comparable analogy would be if a person wanted to place a bet on a horse race but had their spouse do it instead.

Wintoki, who co-wrote the paper with Bradley Goldie of Miami University, Chao Jiang of the University of South Carolina and Paul Koch of Iowa State University, notes that 18% of all trades are indirect insider ones. His team hand-collected data from files containing the individual Form 4s filed by insiders electronically, which are available on the Securities and Exchange Commission (SEC) website. The files indicate (in field No. 7) whether these are direct or indirect trades.

"Employees can do insider trades, too," he said. "However, the reason why we have this data is that rank-and-file employees don't have to tell the SEC, but executives, managers, the owners of the firm and directors of the firm have to do so."

That's the "how" part of this research. But why, exactly, do indirect trades outperform direct trades?

He said, "If you think about insider trading, they can be entirely for liquidity reasons. 'I hold stock. But my daughter is getting married' or 'I need money to buy a boat.' If you want to do that, you're unlikely to be doing that in somebody else's account. So if we want to narrow down which trades are most likely to be informed, there's already one reason why you're looking at this unusual set of trades. If you're trading on behalf of somebody else, it's unlikely to be unique personal liquidity."

This isn't necessarily done as a way of avoiding scrutiny by using someone else's platform. Sometimes it's as a convenient way to pass along wealth to a family member, for instance.

"If you buy shares in your own account and eventually sell the shares and give them the money, they would have to pay estate taxes," he said. "Alternatively, if you have good news about the firm, you can just buy the shares in their own account. It's theirs. And it's not subject to gift taxes."

Ultimately, the illegality of this is solely dependent on whether the watchdog agencies catch the individual who is doing it.

"Hypothetically, you can't deliberately trade in the shares of your own firm using private information," Wintoki said.

"When the DOJ or the SEC has enough information to indict you and prove that you deliberately and willingly traded on private information, that's when they will take you to court for trading in your own stock."

Wintoki spent a year as a visiting financial economist at the SEC, where he worked on securities enforcement against insider trading. He has been at KU since 2008, where he specializes in corporate and international finance.

"I'm still surprised how much more informed the indirect trades were," Wintoki said of the key revelation in his research.

"The biggest lesson from this paper is that executives will find ways to make informed trades—and it turns out executives do that in their own accounts but even more so when they trade on behalf of other people."

The study is published in the *SSRN Electronic Journal*.

More information: Bradley A. Goldie et al, Indirect Insider Trading, *SSRN Electronic Journal* (2018). DOI: 10.2139/ssrn.3270095

Provided by University of Kansas