Study finds insiders profit as companies falter

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(PhysOrg.com) -- Insiders have reaped substantial profits from increased trading of a faltering company's stock when the firm is renegotiating its debt, according to a study by researchers at the University of Otago and the University of California, Davis.

Last month, at the annual New Zealand Finance Colloquium held in Christchurch, the New Zealand Institute for the Study of Competition and Regulation (ISCR), based at Victoria University, awarded the study the prize for best paper on financial regulation.

The aggregate return to insider traders - the sum of their losses avoided from selling and their gains from buying stock - approached nearly (US) $2 billion over the eight-year period analysed in the study led by Professor Paul Griffin, of UC Davis.

Together with Dr David Lont and Kate McClune of the University of Otago's School of Business, Professor Griffin tracked insider stock transactions during or near 1718 first-time disclosures of debt covenant violations by US public companies between 2000 and 2007.

The waiver of a debt covenant is an important step taken by a lender to resolve a company's debt problems and help bring the company back to financial health. Companies must publicly disclose violations of debt covenants and the negotiated outcomes with lenders to the Securities and Exchange Commission. A waiver of a covenant not only gives the company a better chance to succeed but may also be preferred by the lender not wanting to initiate costly bankruptcy proceedings.

The researchers documented increased insider selling as stock prices dropped just before disclosures of debt covenant violations, partly because of uncertainty that the company could go bankrupt. These stock sell-offs were followed by increased insider buying following the disclosures, as stock prices recovered in response to the company's turnaround.

Dr Lont says those who typically lose out from this type of trading are non-privileged investors who might have sold earlier had they known about the covenant violation.

He believes the issue does apply to New Zealand companies because a recent precedent has been set that makes debt covenant violations and waivers fall under the NZX's continuous disclosure rules.

"New Zealand could easily avoid this situation by requiring companies to reveal debt covenant violations and waivers promptly to the market and eliminate insider trading around debt-negotiations," he says.

"Furthermore, to remove all doubt, it should be made clear that the waiver of a debt covenant is of market relevance. Our evidence and prior research show that it is."

Dr Lont says the NZ Securities Commission should review the existing rules to ensure the adverse effects shown in this research are sufficiently covered by the NZX rules regarding debt covenant disclosures to the NZX; and that companies have appropriate insider trading trading policies in place.

"Prompt public disclosure of all insider buys and sells would allow for improved monitoring of unusual behaviour around a material disclosure event. If disclosure was done using a data-friendly format that would also help the investing public."

The researchers also examined whether insiders trading in the US companies mimic the swings in stock price or actually place their trades ahead of the market using their perceived "insight" based on non-public information. The researchers' statistical

analysis showed that insiders sell one to two months ahead of the market decline that precedes the disclosure, and buy one to two months ahead of the market recovery.

The authors also considered other reasons for spikes in insider trading such as earnings reports and other filings, but found no other simple explanation for buying and selling that could account for roughly US $1.97 billion in profits over the eight-year study period. The study ended before the stock market crash in 2008.

"We find strong circumstantial evidence of what some may see as illegal insider trading that cannot be attributed to other factors. But the trouble with this type of insider trading is that the risk of liability or prosecution for the insider is low because the trading typically takes place weeks or months before the public disclosure," Professor Griffin says.

A requirement introduced in 2003, under which insiders must report their trades to the US SEC within two days of the transaction date, seems to have lowered insiders' propensity to trade ahead of the market, the study showed. That is good news for regulators and the average investor.

Dr Lont has prepared an article based on the prize-winning paper. This will be published in an upcoming edition of ISCR's newsletter Competition and Regulation Times due out in July.

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