

INSIGHTFUL INSIDERS?

Do insiders trade more when a company renegotiates its debt? Research into untimely disclosures in the US around the time of companies' debt-covenant waivers suggests they do.¹

Paul Griffin (University of California, Davis) and David Lont and Kate McClune (University of Otago) provide ample evidence on this by tracking insiders' transactions before and after the disclosure of a company's receipt of a debt-covenant waiver.²

The paper documents increased insider selling prior to the waiver disclosure (when stock prices dropped, partly because of the uncertainty of bankruptcy), followed by increased insider buying after the disclosure (as stock prices recovered in response to the turnaround). According to the authors, this V-shaped pattern of insider selling followed by insider buying during covenant-disclosure month is unusually distinct and compelling (see Figure 1). It is also logical – because there is typically quite a gap between insiders' knowledge of a covenant waiver and when outside investors receive that information in a press report.

The study also examined whether insiders simply mimic the swings in stock price or actually place their trades ahead of the market, using their so-called 'insight'. Its statistical analysis clearly shows that insiders sell one to two months ahead of the pre-disclosure market decline and buy one to two months ahead of the market recovery.

The authors looked for other obvious explanations for the trading (such as earnings reports or other filings) but found none.

Although the study shows circumstantial evidence of what can be seen as illegal insider trading, the risk of liability or prosecution for the insider is low because the trading typically takes place weeks or months before the public disclosure (when investors push prices lower). And despite negative market responses to the disclosures in the three days around the announcement (see Figure 2), it can still be extremely difficult to establish a 'smoking gun' connection between the trade and the unfair profits from it.

¹ PA Griffin, DH Lont, & K McClune (2010) 'Insightful Insiders? Insider Trading and Stock Return Around Debt Covenant Violation Disclosures' UC Davis Graduate School of Management Research Paper 07-10 (available at <http://ssrn.com/abstract=1685973> and at http://www.iscr.org.nz/f661,18650/18650_258.pdf)

² A debt-covenant waiver is an important step taken by a lender in resolving a company's debt problems to help bring a company back to financial health. Companies disclose the waiver in an SEC filing (Form 10-K, Form 10-Q or Form 8-K), which was the source of data for this study.

Insiders' profits appear to be substantial. The authors calculated the unfair gain to insiders (and the losses they avoided) from buys and sells around the time of 1718 covenant-waiver disclosures between 2000 and 2007: it comes to roughly US\$1.97 billion.

However, a 2003 requirement for insiders to report their trades to the Securities and Exchange Commission within two days of the transaction date seems to have lowered insiders' propensity to trade ahead of the market, which is good news for the regulators and the average investor.

The paper makes a timely contribution to the larger canvas of studies on insiders' activities during debt renegotiation. The behavior evidenced empirically in this paper has also been demonstrated in studies of creditors' committees. Furthermore, the United States Securities and Exchange Commission has brought several actions of insider trading (in stock and debt) by members of such committees who allegedly have breached confidentiality agreements. It is hoped that this literature will lead to better informed decisions by US regulators and prosecutors when they seek criminal charges against the accused.

The paper on which this review is based won the ISCR Best Paper Prize at the 2011 New Zealand Finance Colloquium, held in Christchurch on February 10 and 11.