Opportunism as a Firm and Managerial Trait: Predicting Insider Trading Profits and Misconduct

Overview

Firm insiders often hold a substantial fraction of their personal portfolios in the stocks and options of their firms. They also have valuable private information about their firm which may provide them the opportunity to buy before good news and sell before bad news becomes public. Such trading activity, however, falls under careful scrutiny by regulators and is commonly restricted by firms. Nonetheless, such trading by insiders is not so rare. For instance, about 14% of all insider trades in 2014 were executed in the one-month period leading up to quarterly earnings announcement (QEA) dates. Identifying opportunism using profitability of all past insider trades is problematic due to the mixture of trading motivations (such as diversification and liquidity needs after option vesting) and since insider information varies greatly in resolution timing. The authors propose a new, more reliable, approach to obtain such information — identifying opportunistic insider traders through the profitability of their trades around QEAs. The authors use this approach to explore whether insiders identified as opportunistic by their measure make more profitable trades in the future. They also explore whether such opportunistic trading is related to other types of managerial and firm misconduct, such as earnings management, SEC enforcement actions, shareholder litigation, and excessive executive compensation.

Investigation

Insider trading activities offer a window into opportunism by managers. The authors hypothesize that many insiders opportunistically use valuable inside information. However, detecting motivation is quite challenging due to a mix of reasons insiders might trade. For instance, managers typically hold a significant portion of their wealth in company stock and options, so they may trade their company stock because they wish to diversify their portfolio or need liquidity to meet option vesting needs. The authors propose an approach to ascertaining the motivations of the insider. This is to identify opportunistic insiders as those that made high profits when trading around QEAs. Specifically, this group initiates trades between 23 and 2 days prior to the QEA (pre-QEA period), and then has strong performance for the 5-day window around the actual QEA event. The opportunistic traders are those insiders who rank in the top quartile based on the profitability of their past pre-QEA trades. There are roughly 14,600 unique insiders who cumulatively make over 90,000 trades during the sample period. The results are as follows:

- A long-short strategy based on the trades of opportunistic insiders (not limited to just their pre-QEA trades) generates positive, significant 4-factor alpha of 1.12% per month which is more than twice as large as the same strategy constructed from trades of all insiders.
- Unlike most previous studies, the authors find a significant effect on the short side as well.
- Opportunistic trading can also identify other kinds of managerial opportunism or misconduct. A higher fraction of opportunistic insiders at a firm is associated with more restatements, SEC investigations, lawsuits for financial misconduct, and earnings management (absolute discretionary accruals). A high fraction of opportunistic insiders is also associated with higher excess compensation among top firm executives across firms in the sample.

Conclusion

Boards, shareholders, bondholders, and regulators may benefit from knowledge regarding insider trading and its motivation. The authors argue that opportunistic insider traders can be identified through the profitability of their trades around quarterly earnings announcements. The subsequent general trades of opportunistic insiders (those with high past pre-QEA profits) are substantially more profitable than those of other (non-opportunistic) insiders. A long-short trading strategy based on trades of opportunistic insiders earns monthly 4-factor alphas of over 1 percent per month. The authors further find that opportunistic trading is associated with various other kinds of managerial misconduct including earnings management, restatements, SEC enforcement actions, shareholder litigation and excess executive compensation. Past trading profitability may therefore provide a useful tool for boards of directors, shareholder groups, and regulators in monitoring and perhaps deterring managerial opportunism and malfeasance.

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