Insider trading and voluntary nonfinancial disclosures

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Abstract

Voluntary nonfinancial disclosure of product and business expansion (henceforth, PBE) plans occurs frequently in practice and is an important vehicle by which managers convey corporate information to outsiders, but little is known about how managerial opportunistic incentives affect the choice of such nonfinancial disclosures. This study examines whether managers strategically time, and make selectivity in, their voluntary nonfinancial disclosures for self- serving trading incentives. I find strong and robust evidence that managers manipulate the timing and selectivity of their nonfinancial disclosures to maximize trading profits. Specifically, managers tend to disclose bad (good) news on product or business expansion information before purchasing (selling) shares. My results contribute to understanding managers' use of nonfinancial disclosure strategies for fulfilling personal trading incentives, and should be of interest to boards of directors, which monitor and restrict opportunistic disclosures and insider trading within a firm.

Motivation of the research

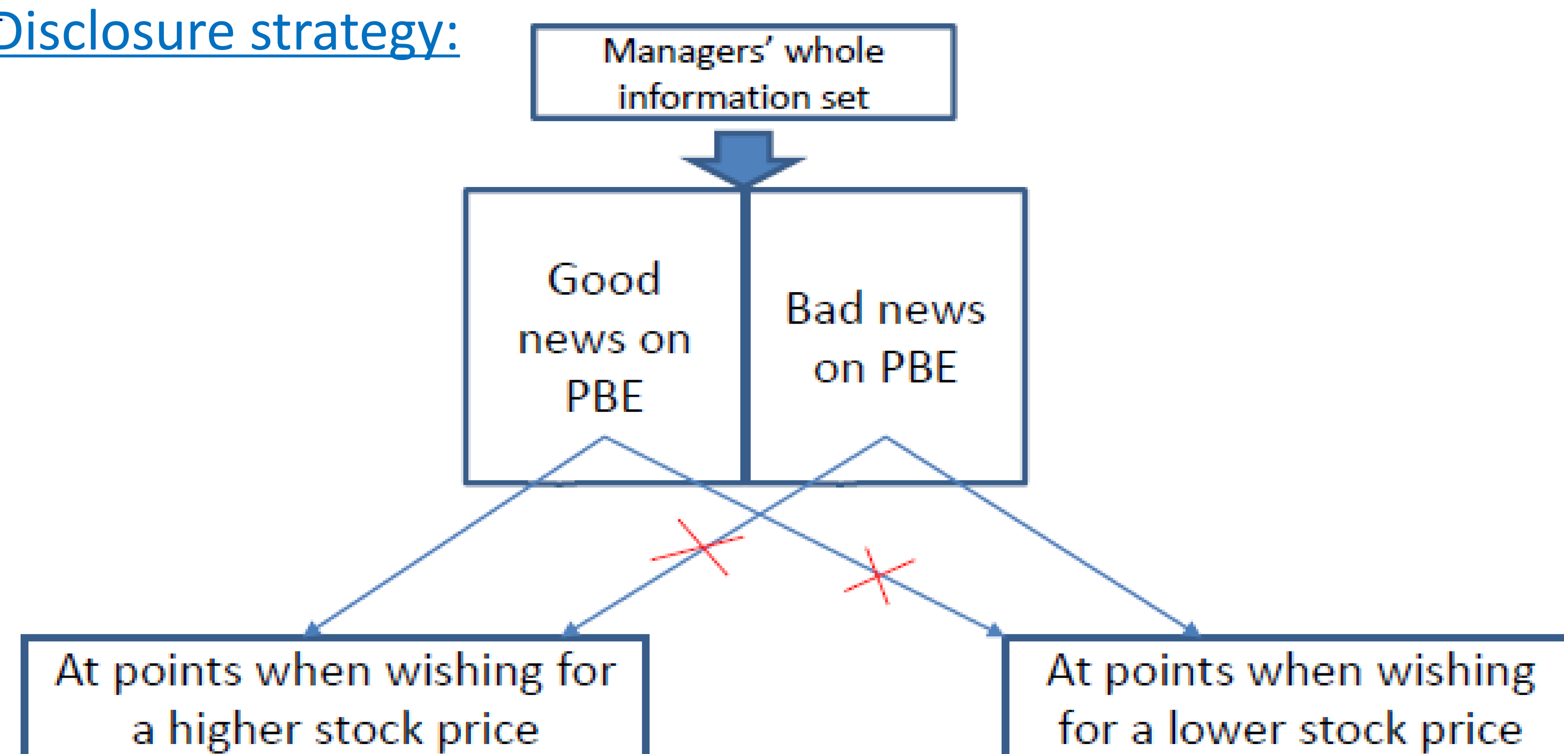
Motivations:

- Withholding information entails substantively lower detection risk and lower litigation risk, compared to disclosing misleading or biased information, and thus is more prevalent among listed companies for fulfilling various opportunistic incentives. PBE plans may contain rich, heterogenous information involving both good news and bad news. Therefore, voluntary nonfinancial disclosures of PBE plans provide a more powerful setting to examine directly the managerial news-hoarding activities than do management earnings forecasts that pertain to an aggregate number bearing good news, or bad news, only.
- The existing literature on the role of managerial incentives in voluntary disclosures focuses predominantly on management earnings forecasts (e.g., Bushman and Indjejikian, 1995; Frankel et al., 1995; Noe, 1999; Aboody and Kasznik, 2000; Lang and Lundholm, 2000; Negar et al., 2003; Cheng and Lo, 2006; Brockman et al., 2008; Rogers, 2008; Cheng et al., 2013; Baginski et al., 2017), with few concerns about voluntary nonfinancial disclosures. Moreover, this disclosure literature focuses on the litigation costs associated with managerial opportunism, with little regard to reputation costs. Thus, despite of the findings of this literature, it is unclear, and hence an open question, whether managers tend to strategically disclose PBE plans before stock trades to grab more trading gain, when taking into account the reputation costs as well as the differences between management earnings forecasts and PBE disclosures.

Research question:

- whether and how insider trading provides managers with incentives to make strategic disclosures of product and business expansion plans to the public
  - whether managers tend to selectively release good (bad) news, and withhold bad (good) news, on PBE information to inflate (deflate) stock prices at the points when self-serving opportunities arise.

Disclosure strategy:



Management earnings forecasts (MEG)	Vs. Product or business expansion disclosures (NF)
Detection risk: MEG > NF	
subject to ex post discipline from subsequent audited earnings reports	hard to be verified ex post by outsider investors in a short run
Influences on stock prices: MEG < NF	
has implication for only the short-term prospect of a firm's earnings performance	has implication for the long-term streams of a firm's future sales and earnings
investors could wait a bit longer to make their investment decisions until after the public release of a firm's audited earnings report	earnings announcements can barely contaminate the announcement effects of nonfinancial disclosures
Flexibility & discretion: MEG < NF	
Sticky: commit to providing continual earnings forecasts or to non-earnings-forecast	un-scheduled, occur sporadically.
an aggregate number reflecting a firm's projected earnings performance and bearing good news, or bad news, only	involve rich, specific, and heterogenous information, including both good news and bad news, from which managers can make selectivity to impact stock prices.

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Do managers tend to manipulate the timing and selectivity of PBE disclosures before stock trades?

Are the expected costs associated with this strategic behavior *higher* or *lower* than the expected gain?

- ✓ Expected benefits:
  - higher trading gain from purchasing (selling) stocks at a deflated (inflated) price
- ✓ Expected costs:
  - Litigation costs associated with insider trades
    - High for insider sales: The resultant stock price decline would constitute a real damage to the wealth of incumbent shareholders who fail to trade duly.
    - Low for insider purchases: (i) The related stock price increase would only result in opportunity costs which are not regarded as damaging to an investor; (ii) Insider purchases could be alternatively construed as insiders' signaling their optimistic beliefs in a firm's future prospect.
  - Detection risk * reputation costs incurred (manifested in the economic costs associated with a firm's future investments and operations) once the incomplete or untimely PBE disclosures are detected
    - Reputation risk is low for manipulating the timing and selectivity of PBE disclosures
    - managers can defend to investors and analysts against reputational losses by arguing that at that point, they do not get known, or do not know with certainty, about the news.
  - Detection risk * litigation costs that are incurred once the disclosure manipulation is detected
    - Litigation risk is low for manipulating the timing and selectivity of PBE disclosures
    - it is too difficult for investors or analysts to discern whether at a particular point in time, insiders are ignorant of news or are deliberately withholding news.

Baseline regression model

$$GBnews = \alpha_0 + \alpha_1 Insiderbuy + \alpha_2 Insidersell + \alpha_3 Controls + \varepsilon$$

Disclosure news:

- Good (bad) news disclosure if the cumulative abnormal returns over the 3-day window centered on the product/business expansion disclosure date are positive (negative).

Insider trading incentives:

- Insider trades in the 30-day period after a disclosure (e.g., Neo, 1999; Ke et al., 2003; Cheng and Lo, 2006; Cheng et al., 2013)
  - Insider sale measure (*insidersell*): The natural logarithm of one plus the amount of net insider sales (i.e., insider sales minus insider purchases) over a 30-day period after a product or business expansion disclosure, if a firm has a positive amount of net insider sales over the 30-day window, and equals 0 otherwise.
  - Insider purchase measure (*insiderbuy*): The natural logarithm of one plus the amount of net insider purchases (i.e., insider purchases less insider sales) over a 30-day window after a product or business expansion disclosure, if a firm has a positive amount of net insider purchases over the 30-day window, and equals 0 otherwise.

Endogeneity and identification strategies

Sources of Endogeneity:

- Correlated-omitted variables bias:
  - There might be some unobservable firm characteristics that drive both insider trading decisions and voluntary PBE disclosures.
- Reverse causality:
  - Insider sales (purchases) may be simply a passive response to the increased (decreased) stock price that follows a good (bad) news PBE disclosure.
- Measurement errors:
  - The post-PBE-disclosure insider trades do not accurately capture the *ex ante* insider-trading incentives.

Identification strategies:

- Studies on insider trades around corporate disclosures over narrow windows, as compared to long windows, are less subject to endogeneity.
- If correlated-omitted-variables bias is at play, we should have expected a bad (good) news, rather than good (bad) news, disclosure accompanied by insider sales (purchases).
- Use of an alternative estimation window of [-210, -11] plus [2, 52] for the disclosure news measure helps mitigate the reverse causality.
- Use of a firm-fixed-effects regression model for the hypothesis tests.
- A reduced-form difference-in-difference specification where the treatment variables are replaced with variables for change in insider trades around a product or business expansion disclosure.
- 2SLS
  - Instruments: (i) stock option grants; (ii) lagged insider trading before product or business expansion disclosures.
- Falsification test
  - If it is the trading incentives that drive the disclosure decisions, I should find no results for trades made by the non-executive employees.
    - If it is the alternative explanation that drives the main results, I should find similar results for trades by the non-executive employees.
  - I randomly fake "event" dates in the non-PBE disclosure period, which is defined as the period outside of the window of [-30, 30] relative to the PBE disclosure dates, then code good/bad news based on the abnormal stock returns to those fake events, and look at the insider trades subsequent to these events.
    - If there is no association between the coded good/bad news and subsequent insider trading, the passive trading explanation can be ruled out.

Key findings and conclusion

Managers tend to strategically alter nonfinancial disclosure policies to fulfil self-serving trading incentives.

- Managers tend to release bad (good) news on product or business expansion information prior to purchasing (selling) shares.
  - Litigation risk associated with insider sales does not manifest itself in nonfinancial disclosures, typically, PBE disclosures, which entail low disclosure risk.

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