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Can Insider Trading Information be a Useful Tool for Investment Managers?

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For decades, institutional investment managers and individual investors have searched for different ways to make outsized returns in the stock market. Predominant finance theories formulated by academics suggest this task is not possible because the market is efficient. However, as a scholar-practitioner with 24 years in the investment management industry, I have discovered that Insider Trading disclosure data provides a unique information signal that can be a useful tool for identifying profitable investments at the company level.

Can legal insider trading disclosure data reported to the SEC provide an effective tool for identifying investments at the company level?

With such high profile legal cases like Martha Stewart's, negative attitudes toward insider trading abound in the public eye. However, certain types of insider trading are sanctioned by the Securities Exchange Commission. This review examines the scholarship surrounding legal Insider Trading. Academicians began researching Insider Trading in the 1970s, noting the intimate knowledge that those within a company have that those on Wall Street lack. This unique understanding of company information can lead to abnormal returns on investments. Upon reviewing the various views of Insider Trading noted in the literature, this review notes practical application of the practice for investment managers, particularly in conducting security analysis in light of new disclosure regulations implemented in 2002. Finally, the broader benefits of Insider Trading for the field of identifying investments are also noted.

Keywords: Efficient Market Hypothesis, Electronic Filings, Ethics, Financial Market Anomaly, Insider Trading, Insider Transactions, Inside Information, Information Content, Sarbanes-Oxley Act, Stock Returns.

When individuals hear of insider trading, thoughts of Martha Stewart and her famous insider trading conviction often come to mind. Her conviction highlights the negative perception held in the popular view. Under this view, insider trading is defined as "trading on price-relevant information that is not in the public domain" (Keenan, 2000, p. 71).

The reality of insider trading is less straightforward. Morland states, "It should come as no surprise to anyone that insider trading occurs every day in the stock market… what might surprise investors is that much of it is done with the full knowledge and sanction of the U.S. Securities and Exchange Commission" (Morland, 2000, p. xi).

In contrast to Martha Stewart and others who have traded on non-public, material information, we define *Insider Purchases* as legal open market purchase orders placed by corporate insiders with their own money. This research study focuses primarily on public information from legal insider purchases.

A basic objective of any investment manager is to identify and select investments that will outperform the market. However, there are a variety of different ways to approach this task. As a fundamental bottom-up investment manager, I review corporate financial information to determine if a company is a good investment. A micro-investor is concerned with identifying company specific trends. Combining reliable financial information, like sales and earnings numbers, with public insider trading data can create a powerful tool for evaluating a company's stock for investment purposes.

In finance theory, insider trading falls within the category of anomalies. Goukasian, Ma, and Zhang state, "because these return patterns are not explained by either Capital Asset Pricing Model (CAPM) or a multifactor asset pricing model, they are often referred to as anomalies" (Goukasian et al., 2016, p. 299). Furthermore, Mahakud and Dash suggest that traditional finance theory, like the Capital Asset Pricing Model (CAPM) and Arbitrage Pricing Theory (APT), is in a different category than market anomalies like insider trading. They state, "These empirical phenomena are commonly called CAPM anomalies or financial market anomalies" (Mahakud & Dash, 2016, p. 236).

The finance theories above are stated solely to identity insider trading within the scope of this article. Although defining insider trading within the literature stream of finance theory may seem trivial, categorizing it is crucial because it provides the most accurate foundation for conducting practitioner research.

In addition, corporate insiders tend to be contrarian investors, and take advantage of gaps and dislocations in their company's stock price. Rozeff and Zaman argue that "profits can be earned when outsiders act on the publicly available information concerning insider transactions" (Rozeff & Zaman, 1998, p. 43). Better yet, insiders have the ability to take action to support their opinions by placing open market purchases in their company's stock.

Insiders have a discloser requirement by the SEC that must be submitted on-line by filing a Form 4 document within two days of the insider transaction; a blank form is available on the SEC's website (https://www.sec.gov/about/forms/form4.pdf). The information on the form becomes public and available to all market participants.

Debate on insider activity has centered on a few key points:

1. Insiders consistently have demonstrated abnormal market returns
2. The change and structure of the SEC disclosure requirements for insiders, which has improved outsiders' use of insider trading information.
3. Ethics relating to insider trading because the topic brings forth confusion and ethical issues.

Methodology

The main strategy for my research was finding scholarly top-tier journal articles relating to insider trading. The starting point was a search string that used several different terms, including "insider purchases," "open market purchases" and "insider information," to narrow the search. Also, the term "insider trading information" was taken from the research question as the main search term. Based on feedback from the *Muma Business Review's* Editor-in-Chief, I expanded my search methodology to include a broader range of literature particularly relating to ethics. My search string included the terms "insider trading ethics" and "insider trading law".

The second part of my search strategy was choosing database sources. First, I used ABI-Inform and Google Scholar research databases to find relevant articles. Then, I refined my literature search with three additional databases (Scopus, Web of Science and Business Source Premier) to find recent articles with a higher citation count.

The goal was to narrow the search to journal articles that were singularly focused on insider purchases within insider trading. I eliminated quite a few articles as some were off topic or identified only one feature connected to insider trading. For example, one eliminated article was on insider trading and stock returns around debt covenant violation disclosures. Overall, 35 articles in the literature were systematically analyzed; I chose 18 articles that had the most relevance and rigor on the subject of insider trading and ethics.

Table 1: Insider Trading Research Findings

Finding	Sources
Insiders do possess special information. Results indicate that much information contained in the trades remains undiscounted by the publication date in the official summary (p. 427). Insider data contains information on future stock prices, a finding inconsistent with much of the research on efficient capital markets (p. 428).	Jaffe (1974)
The insider assesses the undervaluation or overvaluation of his corporation's securities by the market according to the way he expects a particular piece of information to affect the future market price of those securities (p. 213).	Finnerty (1976)
Insiders obtain trading gains from the use of inside information. The answer to this question has clear implications for market efficiency: under the semi-strong form of the efficient market hypothesis, all public information is fully reflected in prices (p. 69). Insiders outperform the market, thus refuting the strong form of the efficient market hypothesis (p. 70).	Givoly & Palmon (1985)
Insiders predict abnormal future stock price changes. Insiders possess differences in the quality of information. Insiders who are expected to be more knowledgeable with the overall affairs of the firm, such as CEO, board of directors, or officers, are more successful predictors of future abnormal stock price changes (p. 210). The realizable return to outsiders is examined. Following the public dissemination of insider-trading information, the abnormal return to outsiders, net of the bid-ask spread plus the commission fee is non-positive (p. 211).	Seyhun (1986)
Concerning strong-form market efficiency, the evidence examined indicated a level of insider trading profits of, at most 5% annually, rejecting the strong-form efficiency in a statistical sense (p. 39). Outsiders earning abnormal returns by using publicly available insider trading data constitutes a serious exception to stock market efficiency (p. 25).	Rozeff & Zaman (1988)
Outsiders can earn significant abnormal returns by mimicking such trades (p. 57). This conclusion is consistent with a growing body of empirical literature that suggests that the market is not efficient in the semi-strong form (i.e., is not efficient with respect to all publicly available information) (p. 57).	Bettis, Vickrey, & Vickrey (1997)
Insiders in aggregate are contrarian investors: however, they predict market movements better than simple contrarian investors (p. 79). Company executives and directors know their business more intimately than any Wall Street analyst ever would. Investors benefit from observing what insiders are doing (p. 79-80).	Lakonishok & Lee (2001)
Information content after Sarbanes-Oxley Act of Form 4 filings leads to greater abnormal return and trading volumes versus pre-SOX. (p. 419). SOX has increased the information content around Form 4 filings (p. 420).	Brochet (2010)
The move to electronic filings improves research and data analysis (p. 1). Electronic filing of changes in ownership began by insiders on June 30, 2003 (p. 3 footnote 4).	Sidgman (2014)
The concept of efficiency is central to finance. For many years, academics and economists have studied the concept of efficiency applied to capital markets, with efficient market hypothesis (EMH) being a major research area in the specialized literature (p. 442).	Titian (2015)
Financial market anomalies are found to be inconsistent with the predictions of traditional efficient markets and rational expectations asset pricing theory (p. 236).	Mahakud & Dash (2016)
There is a common pattern of underreaction to information contained in preceding insider trading activity (p. 229). Return anomalies speak directly to the efficient market hypothesis (p. 239).	Goukasian, Ma, & Zhang (2016)

The research question: "Can Insider Trading Information be an effective tool for investment managers?" is important because as Chan, Ikenberry, Lee and Wang state, "previous papers have found evidence that insider trading is indeed informative and that managers indeed possess timing ability" (Chan et al., 2012, p. 60). I always have believed that tracking and monitoring insider purchases is a great starting point to building a solid investment portfolio.

Literature Summary

Table 1 provides a review of important contributions to the insider trading literature. The sources are listed chronologically, starting with the earliest and moving to most recent.

Discussion

Based on this review, the academic literature suggests a high degree of consensus that investors can benefit from following insider trading. The communication structure of insider data has changed over the years due to updated SEC requirements and law changes like Sarbanes-Oxley. However, the timeless principles of insider information knowledge remain valid today.

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This literature dated back to the early 1970s when academics started to use information technology to study insider trading data and develop statistical models to interpret their findings over a period of time.

Seminal work from Jaffe argued that, "Academicians are interested in the amount of special information insiders possess, as well as in the profit they earn from such knowledge". He concluded, "The data suggests that insiders possess special information" (Jaffe, 1974, p. 410). Two years later, Finnerty's study concluded that "Insiders do rely on future financial and accounting information but that, the relative magnitudes of that information are also important" (Finnerty, 1976, p. 213).

Ten years later, Seyhun attempted to distinguish between insider and outsider profits. He defined outsiders as market participants who can purchase stock following insiders' purchases using publicly available insider trading information. He acknowledged that prior studies "conclude that insiders earn significant abnormal profits by trading the securities of their own firms" (Seyhun, 1986, p. 189).

Seyhun also agreed that the finding of abnormal profits by insiders contradicts the efficient markets hypothesis. However, he asserted that, "Outsiders cannot earn abnormal profits net of trading costs" (Seyhun, 1986, p. 210). Seyhun concluded that, "This evidence is consistent with market efficiency: outside investors cannot use publicly available information about insiders' transaction to earn abnormal profits" (Seyhun, 1986, p. 211). Some would suggest that Seyhun's work is outdated as bid-ask spreads have narrowed and commission levels have substantially declined to $4.95 per transaction. Furthermore, an argument can be made that post Sarbanes-Oxley Act of 2002, insider information is more valuable and timely to outsiders, which creates profit opportunities for outsiders.

Eleven years later, Bettis, Vickery, and Vickery demonstrated that outsiders who mimic insiders can, in fact, profit from using publicly traded available insider-trading data. Bettis, Vickery and Vickery argued that "Seyhun was forced to use less-precise dates of widespread public availability because at the times of their studies, services that conveyed insider-trading data to investors on timely basis were not available" (Bettis et al., 1997, p. 58). In their study, Bettis, Vickery and Vickery (1997) showed that insiders' abnormal returns persist for extended time periods.

Lakonishok and Lee studied information content in insider trading data and had several interesting observations. They found that, "In spite of the extensive coverage that insiders' activities receive, the market basically ignores this information when it is reported. Moreover, there is very little action around the time when insiders trade" (Lakonishok & Lee, 2001, p. 107). Basically, Lakonishok and Lee (2001) contended that no one jumps to take action on this information right away and this valuable information is ignored by market participants.

More recent studies by Sidgman and Brochet reported that changes in insider trading disclosure rules and the move to electronic filings have had a large positive impact on trading volumes and abnormal returns by insiders (Sidgman, 2014). According to Brochet, "Abnormal returns and trading volumes around filings of insider stock purchases are significantly greater after the Sarbanes-Oxley Act of 2002 than before" (Brochet, 2010, p. 419).

Prior to 2002 and SOX, insiders were only required to disclose their trades after 10 business days. After SOX, the new disclosure rule was put in place that required only two business days. According to Sidgman, "Trades that, prior to SOX, would have been spread over a 40-day reporting period but filed on a single Form 4, are now broken down into larger numbers of smaller trades that are routinely filed".

Sidgman stated, "Recent evidence also suggests that a more timely disclosure of insider trades is relevant for pricing securities" (Sidman, 2014, p. 3). In support of this view, a cluster pattern effect that can be described as a stronger signal has been observed. For example, group of insiders, when considered together, could send a stronger signal to the market by their open market purchase behavior than just one individual alone.

Bodie, Kane, and Marcus discussed portfolio strategies and market anomalies highlighting the neglected-firm effect, liquidity effects and inside information. They described inside information as follows (Bodie et al., 1993, p. 387):

> *It would not be surprising if insiders were able to make superior profits trading in their firm's stock. The ability of insiders to trade profitability in their own stock has been documented in studies by Jaffee, Seyhun, Givoly & Palmon and others. Jaffee's was one of the earlier studies that documented the tendency for stock prices to rise after insiders intensively bought shares.*

Gitman and Joehnk described market anomalies as "irregularities or deviations from the behavior one would expect in an efficient market" (Gitman & Joehnk, 2008, p. 409). They discussed the January effect, small-firm effect, earnings announcements and behavioral finance as forms of market anomalies. However, insider trading was absent from their discussion. Some popular finance textbooks discount the importance of insider trading information.

However, conclusions regarding the potential value of insider information to outsiders are not unanimous. Advocates of the efficient market hypothesis certainly would take issue with the argument that legal insider purchases can create abnormal returns over time. Titan states "In the modern theory of finance, a good starting theory is that of efficient capital markets" (Titan, 2015, p. 442). Fama developed the framework for three forms of the efficient market hypothesis: 1) weak form; 2) semi-strong form; 3) strong form (Malkiel & Fama, 1970). Keenan argued, "The distinction between strong and semi-strong form tests maps the distinction between market behavior with and without insider trading" (Keenan, 2000, p. 72).

The debate of the efficient market hypothesis is beyond the scope of this article. However, Titan argued, "Even if many tried to find the truth behind the EMH, no ultimate conclusion exists. There are many opposing opinions regarding this theory; for each article that confirms the hypothesis, there is another that invalidates it" (Titan, 2015, p. 442). Keenan articulated one such opposing opinion by stating, "Market efficiency is not a univocal term. The allocative efficiency of markets is to be distinguished from the informational efficiency of markets" (Keenan, 2000, p. 72).

Finally, the topic of insider trading brings forth confusion with regards to ethical issues. For example, answers to simple questions such as: "Is insider trading illegal?" or "Is insider trading unethical?" can be extremely baffling. As noted in the introduction, the widespread perception is that anything to do with insider trading is, in fact, not legal and has led to an epidemic of fraud in capital markets for decades.

According to Ma and Sun, "It is important to understand that insider trading is not all based on private information. For this reason, not all insider trading is illegal or unethical" (Ma & Sun,1998, p. 68). Indeed, the subject is hotly debated within the field, as illustrated in Table 2, which provides a short review of Insider Trading Ethics research findings.

McGee emphasized that "A typical case of insider trading occurs when a buyer with inside information calls his stock broker and tells him to buy, knowing that the stock price is likely to rise as soon as the inside information becomes public" (McGee, 2008, p. 207). According to Skaife, Veenman, and Wangerin, "Managers are responsible for the effectiveness of their firms' internal control as well as the reliability of external financial reporting. These same officers are able to transfer wealth from shareholders to themselves by trading on their private information" (Skaife et al., 2013, p. 107).

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As is expected when facing any source of potential risk, investment managers need to take ethics and loss of reputation into consideration. The return/risk equation needs to be balanced like any other investment opportunity. One view considers Form 4 open market purchases as neither unethical nor illegal. This public information form creates a signaling tool that market participants appear to be overlooking. Batten, Loncarski, and Szilagyi take the stance that "Ethical behavior is instilled at home, in school and in society, and there is a need for ethical responsibility at the personal level and organizational level to complement legal rules and enforcement" (Batten et al., 2018, p. 779). Going forward, changes to public policy and insider trading regulation could illuminate the view that insider trading is illegal and unethical.

Table 2: Insider Trading Ethics Findings

Finding	Sources
Opponents of insider trading seem simply to believe that insider trading is inherently immoral (p. 67). **Proponents, on the other hand, assert that insider trading is a viable and efficient economic means and can be used to serve the best interests of shareholders and the economy at large (p. 67).** **They argue that insider trading is not necessarily unethical or illegal (p. 68).**	**Ma & Sun (1998)**
Whenever the term insider trading is used, the average listener/reader immediately classifies it as a bad practice or something that is immoral or unethical (p. 207). **The strongest criticism that has been leveled against the U.S.'s insider trading legislation is that the term insider trading was not defined. That omission was deliberate, perhaps because Congress could not clearly define what insider trading was (p. 214).**	**McGee (2008)**
Commentators make it sound like all insider trading is illegal. Yet, some forms of insider trading are perfectly legal and some kinds of insider trading are not unethical. In other words, there is a widespread misperception on the part of the public about insider trading (p. 65). **Arguments against all insider trading say it is inherently immoral to trade on inside information because making a large profit with such little effort is somehow wrong (p. 71).** **Another argument against all insider trading takes the position that insiders have some fiduciary duty not to benefit from the information they have access to as part of their position with the corporation (p. 71).**	**McGee (2009)**
Trading on undisclosed price-relevant information is in breach of moral rights and duties derived from the principle of respect for individual autonomy. It follows that insider trading is an immoral practice (p. 81).	**Keenan (2000)**
Reliable financial reporting is an important mechanism used by firms to communicate creditable information to outsiders for their use in evaluating management's performance (p. 91). **Insider trading profitability is significantly higher in firms disclosing material weaknesses in internal control over financial reporting (p. 92).**	**Skaife, Veenman, & Wangerin (2013)**
They argue that unless the existing compliance-based system of regulatory rules and industry standards come to reflect core ethical values, then insider trading and other illegal and unfair market practices will remain commonplace (p. 780).	**Batten, Loncarski, & Szilagyi (2018)**

Conclusions

Insider trading information has practical application for security analysis. It can be used as a tool for narrowing investment choices and separating winning stocks from losing ones. Insider trading information is often overlooked as a domain. However, in practice, insider data has broader application for investment managers within the financial services industry.

The applicability of this data has changed over time. Prior to the SOX regulation in 2002, insider trading data was reported monthly. Today, information is filed electronically and timely. This change, post SOX, relates to the speed and structure of insider information.

The literature provides evidence that insider purchases produce abnormal returns. These insider signals should provide value to the army of security analysts, portfolio managers and individual investors who choose to follow insider moves.

These findings have important consequences for the broader domain of investing. Market participants tend to act irrationally versus rationally from time to time in relation to their money and the markets. In my view, insiders take advantage of investor irrationality by making purchase decisions based on their unique understanding of their firm's long-term prospects. In conclusion, in the words of Jaffe, "Insiders do possess special information" (Jaffe,1974, p. 424).

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Review

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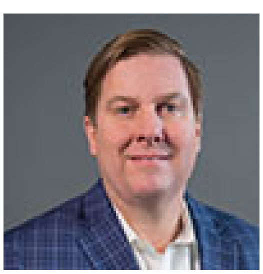

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