An Analysis of Corporate Insider Trading and Earnings Announcements in India

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Initial Basic Questions

- Firms have two ways to persuade investors
  - Insider trades (compliance reports)
  - corporate earnings announcements

- **Do insiders make money? Do they anticipate returns?**
- **Do they make money before, during, or after an earnings announcement?**

  - **Are their trades consistent with the sign of future earnings news?**

- How does the market react to insider trading, given availability of another significant piece of news, unexpected earnings?

Initial Motivation: Why study insiders?

- Larger samples for insider trades have only recently become available in India (35000 reported trades during 2008-2014)
- Compliance filings presumably reflect legal insider trades (potential evidence on quality of regulation)
- Unlike other informed traders, insiders often have not only hidden information but also the capacity for hidden actions, including for fundamental operating decisions. (Actions may lend credibility to words.)

Motivation: Why focus on earnings announcements?

- Earnings announcements can be focal points (Schelling (1960))
- Important summary numbers (Basu, Duong, Markov and Tan (2013): explain 11% more of returns than many other announcements)
- Earnings announcements can be cheap talk (costless, nonbinding, unverifiable) – raises the possibility that when talk is cheap, actions speak louder than words.

India’s insider trading law

- insider trading law was enacted in India only in 1992 (1992 Regulation superseded by new Act effective since 15th May 2015).
- definition of insider (expanded to include more “connected persons,” blockholders , so even large FIIs are “insiders”)
- prohibits trading on the basis of unpublished price-sensitive information (UPSI) (no abstain-or-disclose rule as in the US; prohibited periods can be expanded by compliance officer)
- outside of these periods, trading allowed but must be reported to the compliance officer.

India’s insider trading law – enforcement

- Enforcement difficult and patchy everywhere (Bhattacharya-Daouk (2002) showed enforcement matters: even one conviction is better than a beautiful law)
- theory of regulatory capture
- In India only in 2009 were related parties considered insiders
- Bombay High Court Order (18th Feb 2005) asking BSE to provide the same kind of data that NSE does, still not implemented. (SEBI was a respondent in the writ petition, but no help since.)

Documentary evidence from SEBI CPIO RTI replies

- SEBI CPIO said they did not have firm-level FII data (when they get daily electronic filings per SEBI's own circular).
- SEB CPIO refused to acknowledge SEBI's own circular of July 2001 requiring these daily electronic filings.
- SEBI CPIO contradicted himself when replying to a Member of Parliament (Rajya Sabha Question No. 402 on 21st Oct 2008)

More anecdotal evidence from SEBI RTI responses

- SEBI adopted peculiar rule about not just masking FII-IDs but also changing them each month.
- SEBI CPIO claims that even stale (more than 6 months old) trade information is market sensitive, and needs protection!! (Ignores its own responsibility under the insider trading law, and the very different assumptions SEBI itself makes in asking for other filings (e.g. insider trading compliance reports)
- Academic research as part of the edifice of checks and balances not recognized; demonstrated adversarial attitude to academic research.

SEBI’s heart is not in enforcement

- Chauhan, Kotha, Marisetty (2012): even after the Galleon case in the US, SEBI showed no enthusiasm for similar wire-tapping powers.

- Very few prosecutions by SEBI.

- Among these prosecutions a large fraction of cases have been lost by SEBI on “technical grounds.”

- Individuals, companies, seem to comply on their own.

More on SEBI’s enforcement

- SEBI prefers “administrative actions” to “criminal prosecutions.” (No Judge Rakoff here to defend the public interest, and impose some discipline on SEBI.)

- Even public reporting is fudged: SEBI says “from 2006-2007 to 2013-2014, the number of ‘completed’ insider trading actions (i.e. regardless of whether they were unsuccessful or successful, leading to criminal or civil penalties) averages about fifteen a year.”

- Even when Appellate Tribunal produces a well-reasoned ruling and convicts someone, the last penalty paragraph shows SEBI’s heart is not in enforcement. (Satyam, Jhunjhunwala, Reliance).

Enforcement – even low-hanging fruit missed

- Simple checking of consistency between different filings. Many instances of insider trading even on announcement date.
- Chauhan, Kotha, Marisetty (2012): even after the Galleon case in the US, SEBI showed no enthusiasm for similar wire-tapping powers.
- Very few prosecutions by SEBI. Among these prosecutions a large fraction of cases have been lost by SEBI on “technical grounds.”
- Why anecdotal evidence matters.

Prior Work: Insider Trades and Earnings

- *Do insiders trade in the same direction as future earnings news?*
  - Early studies found no evidence suggests that institutions are smart (Elliott, Morse, and Richardson (1984), Givoly and Palmon (1985), Seyhun (1992), Allen and Ramanan (1990; 1995), Sivakumar and Waymire (1994).
  - Later studies found some evidence that they Lustgarten and Mande (1995), Ke, Huddart, and Petroni (2003), Wisniewski (2004), Cheng and Leung (2008), Piotroski and Roulstone (2005))

- *What drives insider trading after earnings announcements?*
  - litigation concerns and corporate restrictions (Sivakumar and Waymire (1994), Hillier and Marshall (2002)
  - Exploit the market under-reaction (Huddart, Ke, and Shi (2007), Kolasinski and Li (2010))

More Prior Work: Insider Trades and Earnings

- *Price reaction to earnings surprises are moderated by prior insider trading*

  - Allen and Ramanan (1990, 1995), Udpa (1996): both earnings surprises and insider trading in pre-announcement periods are associated with earnings announcement returns

  - Roulstone (2008): reaction to earnings announcements (measured by return volatility and abnormal trading volume) decreases in the insider-trading volume preceding the announcement.

How does our study relate to prior work?

- Tests of insider trading skill or advantage

- Use daily data
- Use actual trades
- Of one class of investors
- For an entire economy
- From a source that is publicly available (not a proprietary dataset)
- Examines trading over multiple horizons

Data Sources

- Prowess: Annual Financial data, Quarterly Ownership, Daily Prices and Returns

- NSE: Earnings Announcements: EPS and Dates (and Time stamp)

- Ongoing work uses additional insider trading data bases, besides raw compliance filings of insider trades.

- Panel Study with unit of observation = firm-quarterly earnings announcement

Do insiders have an advantage? Predictions

- If insiders possess private information about a future outcome, they can trade ahead of that outcome.

- So we use the earnings as a future outcome and test if insider trading is in the same direction as

  - one-quarter ahead unexpected earnings and
  - one-year-ahead levels and changes in return on assets.

- Insiders can time their trades to take advantage of a known relation between public information and future returns.

Findings – insider behavior

- In India, insiders tend to reduce their trading activity in the weeks before the earnings announcement.
- Insiders profit from their trades (predict subsequent stock returns for up to one year following the trade)

Findings – insider returns vis-à-vis earnings news windows - 1

- A sharp increase in trading during and immediately after the earnings announcement (naked violation of insider trading law).

- Pre-announcement trading is in the same direction as the subsequent earnings surprises .

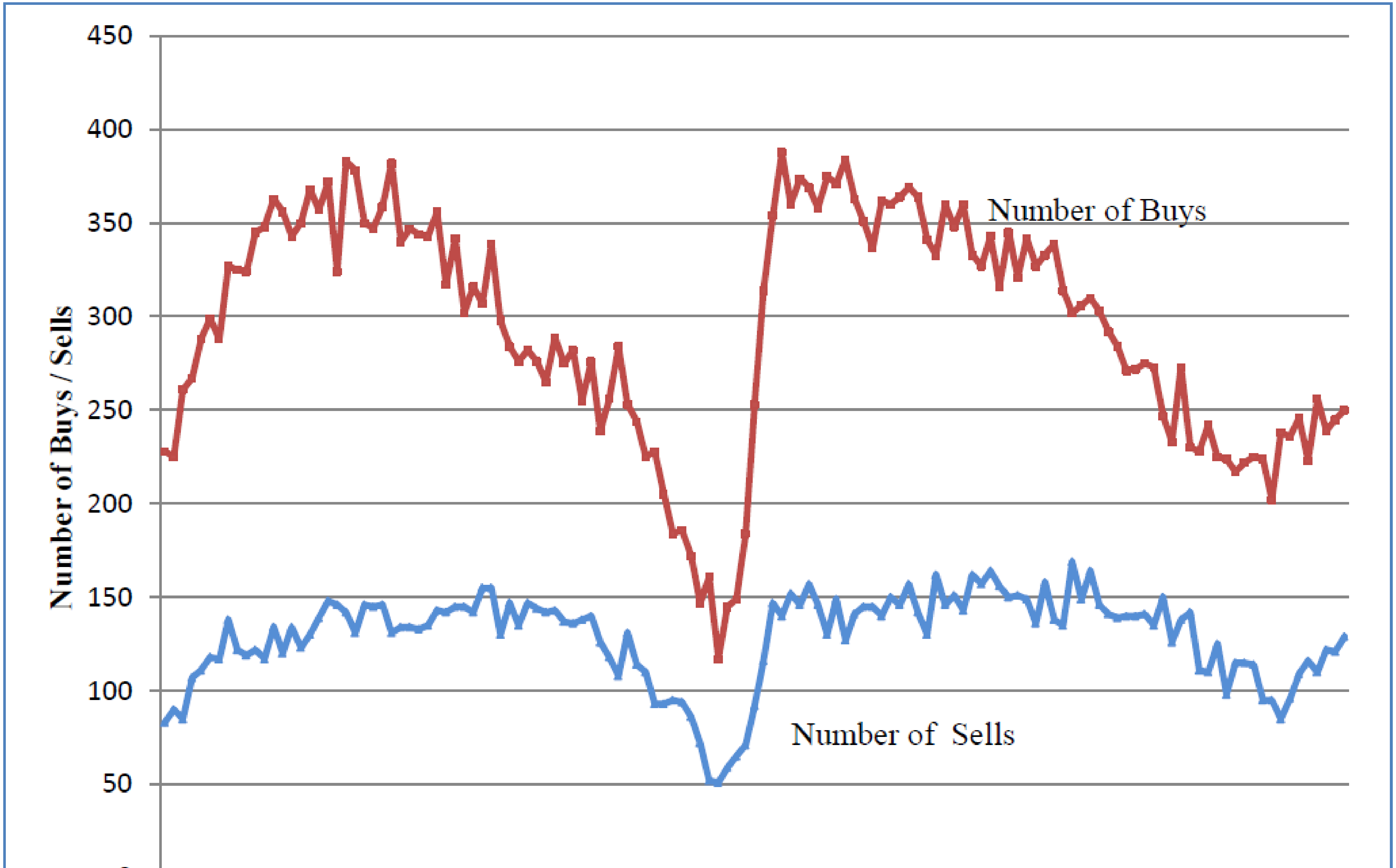
- Pre-announcement trading is positively related to earnings announcement returns.

Findings – insider returns in post-earnings news windows - 2

- Pre-announcement trading is positively related to earnings announcement returns.

- Insider trading during the earnings announcement is unrelated to unexpected earnings.
- Insider trading during the earnings announcement is unrelated to unexpected earnings.

- Post-announcement trading is positively related to unexpected earnings. (So they exploit under-reaction to news which leaves money on the table.)



Number of Buys / Sells
450
400
350
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Number of Buys
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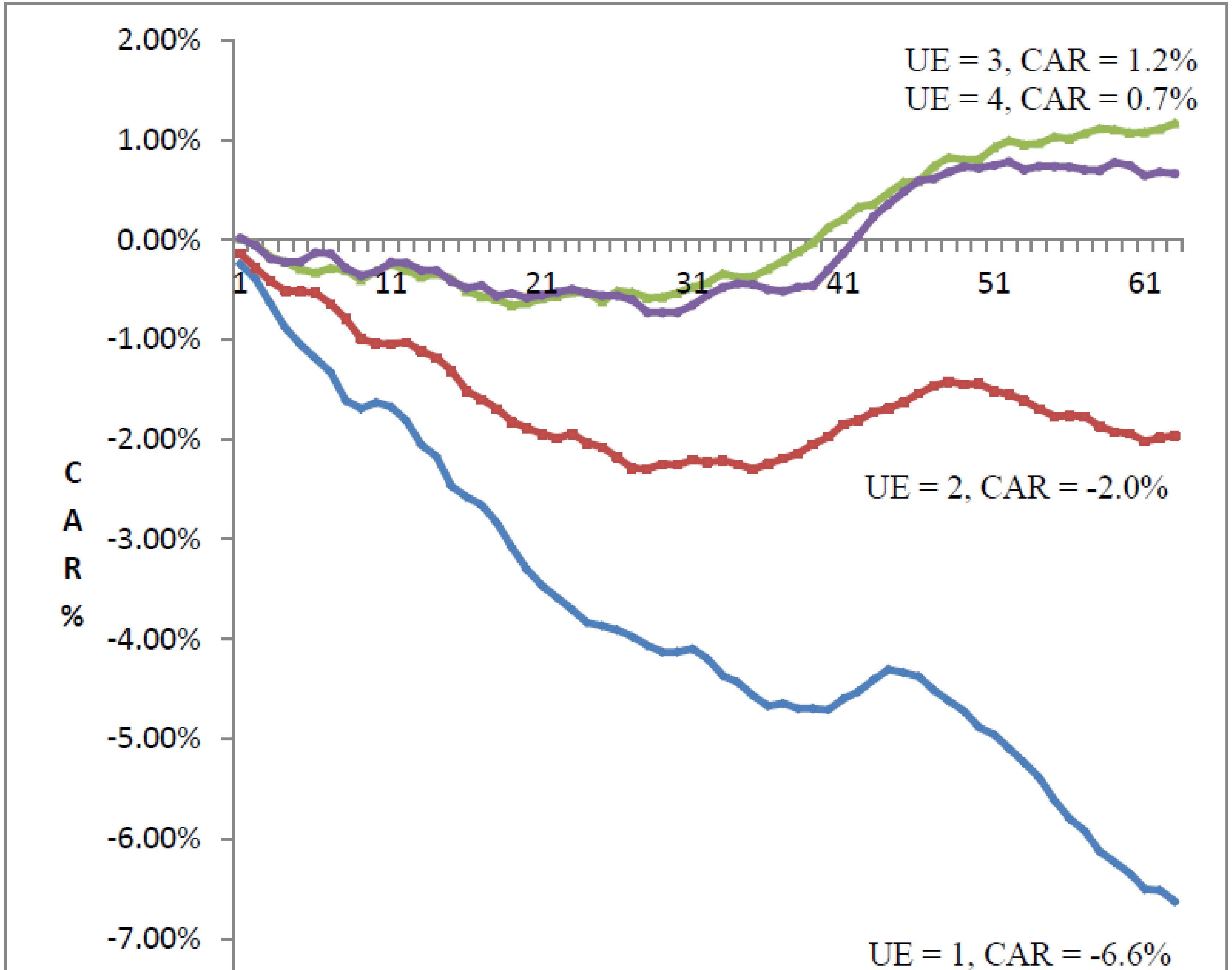
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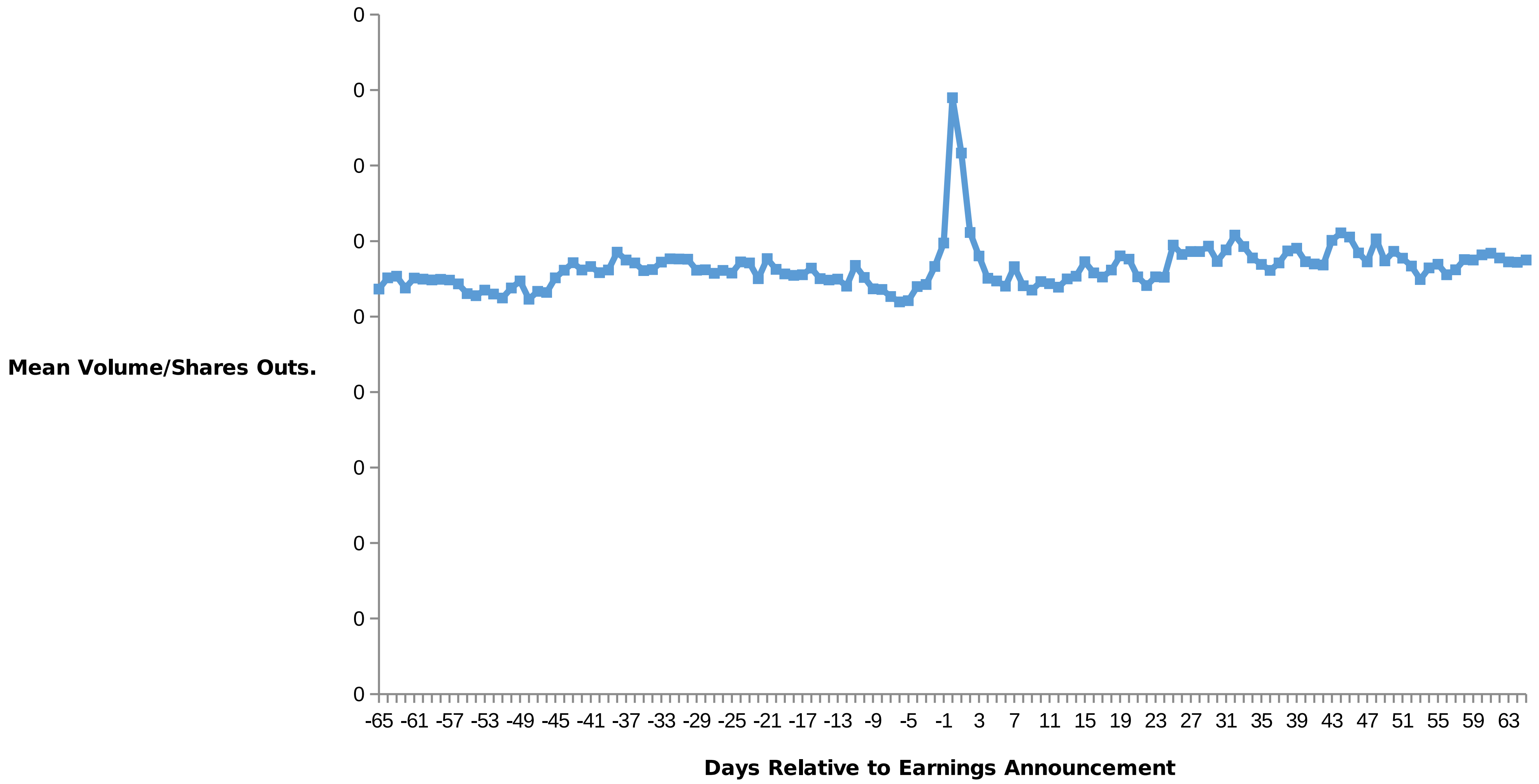
41
51
61
C
A
R
%
UE = 3, CAR = 1.2%
UE = 4, CAR = 0.7%
UE = 2, CAR = -2.0%
UE = 1, CAR = -6.6%

Mean Volume / Shares Outstanding around Earnings Announcements, Figure 1



Market Reaction to Insider Trades: Predictions

- Why would investors react to insider trades?

A. Because they perceive insiders to be informed and insiders are informed.

B. Some investors simple herd and follow insiders (even though the latter are not informed).

Schelling (1960) A focal point is a feature of a situation with a natural saliency that allows for coordination of moves even without any direct communication.

Insiders simply exploit a focal point – the earnings

Market Reaction to Insider Trades: Predictions

- How would investors interpret the two signals: Insider trading and Unexpected earnings, jointly?

- A signal X is a substitute for signal Y if, ceteris paribus, the availability of X causes the posterior belief to rely less on Y.

- A signal X is a complement for signal Y if, ceteris paribus, the availability of X causes the posterior belief to rely more on Y.

- Important because it can
  - clarify the nature of market perception of insider trades and earnings
  - suggest modifications to regulatory responses

Findings – Market reaction to news

- Announcement window returns positively related to earnings news (consistent with widely documented result).
- Also positively related to insider trades.
- Ongoing work assessing whether earnings and insider trades are information substitutes or information complements.

Market Reaction to Insider Trades: Summary

- The market reacts favorably to both insider net buying and earnings news, and

- Assessment of whether the two sources of information are substitutes or complements is part of ongoing work.

Concluding Remarks

- Revision uses a significantly larger sample
- One new goal is to see if among the insiders who file compliance reports, whether those who violate the law appear to have an advantage (a) statistically (b) economically.
- Key question for future research: given extremely lax enforcement, why do so many people bother to comply?