Going public: why directors should tell all

***Ian Ramsay** reinforces the argument for mandatory and prompt disclosure of trading by insiders—directors and officers—in the shares of their companies.*

A requirement that directors and officers of public companies should disclose their trading in the shares of their companies may be imposed for two reasons: the protection of investors and market efficiency. The first reason is based on the argument that if trading by directors and officers on the basis of inside (non-public) information is viewed as undesirable, mandatory disclosure may deter such trading. This was the basis for a recommendation by the Cohen Committee in 1945 that the British companies legislation be amended to require disclosure of share dealings by directors. The committee's report said:

"The best safeguard against improper transactions by directors and against unfounded suspicions of such transactions is to ensure that disclosure is made of all their transactions in the shares or debentures of their companies . . . The fact that disclosure is obligatory will of itself be a deterrent to improper conduct and the shareholders can, if they think fit, ask for an explanation of transactions disclosed in the return which we recommend."

This reason was also the basis for the insider reporting requirements introduced in the United States. The Securities and Exchange Commission (SEC) said in a 1981 release on rules applicable to insider reporting and trading: "Congress believed prompt publicity to be a potent weapon in the effort to curb the abuse of inside information."

A related argument is that insider reporting requirements should be imposed because the evidence provided in the reports facilitates the enforcement of insider trading regulation. For example, in the United States, s16(b) of the Securities Exchange Act of 1934 provides that any profit realised by an insider as a result of a purchase-and-sale or sale-and-purchase of a share of the insider's company within a six-month period belongs to the company. Insider reports filed with the Securities and Exchange Commission in accordance with s16(a) of the act may reveal share trades which are subject to this profit-recovery provision.

Two responses can be made to the justification that insider reporting requirements are a deterrent to insider trading. First, some commentators believe insider trading should not be prohibited; however, most observers of the Australian market, as well as parliamentary committees and parliament itself, have long accepted the need to prohibit insider trading.

The second response is that an insider determined to trade illegally will not be deterred by mandatory

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disclosure requirements. He or she will simply ignore the requirements.

However, this response ignores the trader's exposure to double liability. Not only is there potential liability for the insider trading, which admittedly is often difficult to prove; there is also liability for failing to disclose the actual trading—and breach of this requirement is much easier to prove. There is no need to establish that an *illegal* trade occurred (ie, that the trade was based on inside information). All that must be proved is that the insider traded and that this was not disclosed. Consequently, it may be held that insider reporting requirements do have a deterrent effect.

The second reason for imposing insider reporting requirements is that they can improve the allocative efficiency of the capital markets. Share-trading by a company insider conveys information to the market about the insider's judgment of the prospects of his or her company. Gilson and Kraakman (1984—see references) note that market efficiency is assisted by the wide distribution of information held by company insiders.

Of course, the disclosure of share trading by insiders is only one way of conveying information to the market; another is the release of management earnings forecasts. However, because the insiders are putting their personal wealth at risk by acquiring shares in their companies, the information this represents is particularly convincing.

There may be a concern that public disclosure of such share dealings gives insiders the opportunity to mislead the market. For example, an insider could publicly disclose the acquisition of shares in his company, suggesting a positive assessment of the company's future performance, when he knows this assessment to be false. If the share-price improves, the insider could profit by selling.

This concern can be answered in several ways. First, the Corporations Law prohibits misleading or deceptive conduct in relation to share dealings, market manipulation and rigging (ss995, 997 and 998). Second, the insider puts his reputation (and possibly that of his company) at risk by such trading.

Finally, it can be observed that the two reasons advanced in support of insider reporting requirements cut against each other. The first reason is that such requirements can deter insider trading. The second reason is that public disclosure of share trading by insiders can improve the efficiency of the capital markets. If trading by insiders in the shares of their companies is a useful and desirable means of conveying non-public information to the market, then the first reason (that disclosure will deter such trading) becomes irrelevant.

A number of empirical studies have examined the extent to which insiders can convey information to the market by means of share trading. These studies are discussed following a review of Australian and overseas disclosure requirements.

Current Australian requirements

Sections 235 and 236 of the Corporations Law require a company to maintain a register of shares, debentures, prescribed interests, rights and options in the company or a related company in which each director has a relevant interest.

The director must provide the company with the details to be included in the register within 14 days of becoming a director or becoming aware of having a relevant interest in the shares. Any change in the interest must also be reported to the company within 14 days of the director becoming aware of the change. The register can be inspected by any member of the company and by any other person.

There is no disclosure requirement for officers, and no requirement that share dealings by directors be reported to the ASC or the ASX. However, an ASX precedent was established in January 1992 when, according to a report in the *Australian* newspaper, Centaur Mining & Exploration Ltd was relisted subject to the company complying with stringent disclosure requirements. One requirement obliged directors to inform the ASX each month whether they had bought or sold any securities in the company.

Overseas requirements

The United States, Canada and Britain all have more extensive insider reporting requirements than Australia.

In the United States, s16(a) of the Securities Exchange Act of 1934 requires every officer and director and every person who is directly or indirectly the beneficial owner of more than 10 per cent of any class of equity security of a company with equity securities registered with the SEC to disclose to the SEC, and any stock exchange on which the securities are registered, share dealings which alter the person's beneficial ownership in the company. (The act defines an officer of a company as the company's president, principal financial officer, principal accounting officer, any vice-president in charge of a principal business unit, division or function, or person who performs a policy-making function.) Disclosure must be made within 10 days following the end of the calendar month in which a transaction occurs. Summaries of these reports are published in numerous newspapers and periodicals.

Discussing the circulation of this information in the US, L. Loss and J. Seligman wrote in *Securities Regulation* (3rd edn, 1990):

"In light of the importance of the information provided by [insiders'] filings to investors, many major newspapers routinely publish information gleaned from the reports filed by insiders of selected companies, such as those of local interest. Moreover, there are a number of private newsletters and services that analyze or report trades by reporting persons. Analysts and investors routinely monitor insider trades to detect early warning signs of trouble or positive trends among companies."

Canada's insider reporting requirements are broadly similar to those in the United States. The disclosure requirements apply to directors, senior officers and persons owning beneficially, directly or indirectly, or exercising control or direction over, 10 per cent of the voting shares of the company. Under the Canada Business Corporations Act, disclosure must be made to the regulator within 10 days following the end of the calendar month in which a transaction occurs (as is the case in the United States). However, it has recently been recommended that this period be shortened to within 10 days of the transaction (Consumer and Corporate Affairs 1991).

In Great Britain, a director must notify his or her company of any change in beneficial interest in shares or debentures of the company or any related company. "Beneficial interest" includes the interests of spouses and infant children. Disclosure must be made within five days of the director becoming aware of the change in beneficial interest. The company is required to keep a register of such disclosures and, where the company's shares or debentures are listed on the stock exchange, must notify the exchange within one business day of receiving a report from a director. These disclosures are published by the stock exchange.

Amendments to the London Stock Exchange Listing Rules, effective from 1 July 1992, extend the requirements to interests and dealings by any person connected with a director, including companies with which a director is associated (ie, those in which the director and connected persons control 20 per cent of the shares) and trusts of which a director or an associate company is a beneficiary.

Empirical studies

Can trading by an insider convey information to the market about the insider's company? According to John and Lang (1991), insiders' own trading activity (subject to disclosure regulation) is "one of the most direct signals available to insiders to convey private information to the market". A purchase of shares may indicate the insider's positive assessment of the company's prospects; a sale may indicate a negative assessment.

However, there can be many reasons for trading by an insider. An insider may buy shares because he has non-public information or because he believes, on the basis of publicly available information, that the company's shares are undervalued by the market. A sale of shares may also be based on inside information or an assessment by the insider that the shares are overvalued. An insider may sell shares simply because he or she needs cash.

The critical issue is whether the insider profits from the trade. A purchase of shares by the insider followed by an increase in the price of the company's shares may reflect the insider's positive assessment of the company's prospects. Similarly, a sale of shares by the insider followed by a decline in the price of the company's shares can be seen as an affirmation of the insider's negative assessment of the company's prospects.

The strong form of the efficient capital markets hypothesis assumes that all information (public and private) is rapidly impounded in share prices, with the result that no investor can use this information to profit. This suggests that an insider could not profit by trading on non-public information concerning the insider's company. However, significant evidence that insiders do profit by trading on private information tends to refute the strong form of market efficiency (Syed et al 1989).

There is anecdotal evidence of insiders profiting by trading in the shares of their companies. Beyond the anecdotal evidence, precise studies have been undertaken for those countries which require public disclosure of share trading by insiders.

United States: A series of studies between the 1960s and the 1980s demonstrated that insiders consistently outperformed the market (and hence made abnormal returns) by trading in their company's shares (Lorie 1968, Jaffe 1974, Seyhun 1986). The most recent studies can be divided into several categories.

(a) Takeovers: The announcement of a takeover generally results in a significant increase in the share price of the target company (see Jarrell et al 1988, Bishop et al 1987). Do insiders profit by acquiring shares in their company prior to it being the subject of a takeover?

A recent study (Eyssell 1990) examined the trading of insiders prior to the company being the subject of a "toehold" acquisition (defined as the purchase of a relatively small proportion of the target company's shares for the purpose of launching a bid for control). The study of 57 companies subject to toehold acquisitions found that in the six months preceding a toehold acquisition, there was a significant increase in purchases of the company's shares by insiders—particularly by board chairmen and, to a lesser degree, inside and outside directors.

A conclusion of the study is that insiders, by acquiring shares in their companies, are providing information about the likelihood of the company being a potential takeover target.

(b) Insider trading following the sharemarket crash of October 1987: Several studies have examined the trading response of insiders to the October 1987 sharemarket crash. Seyhun (1990) has demonstrated that, following the crash, insiders became buyers of their companies' shares in record numbers. The shares of those companies that had the greatest decline during the crash were purchased to the greatest extent by insiders following the crash. Moreover, the shares of these companies also showed the greatest recovery following the crash.

Netter and Mitchell (1989) examined the trading of insiders of all New York Stock Exchange, American Stock Exchange and over-the-counter companies in the 40 days immediately following the crash. The authors found that insiders tended to buy shares in their company following a period of poor abnormal share price performance which then preceded a period of positive abnormal share performance. Insiders tended to sell following a period of positive abnormal share performance and the sale was followed by a period of poor abnormal share performance.

The authors state that the results are consistent with the argument that insiders had superior information regarding the value of their companies' shares.

(c) New issue announcements: Karpoff and Lee (1991) examined trading by insiders before announcements of primary offerings of shares, convertible debt and straight debt. In a study of 179 security issues, the authors found that, on average, there were more insider sellers than buyers before announcements of share and convertible debt issues. Citing earlier research findings that share prices generally decrease on the announcement of a new issue of shares or convertible debt, the authors conclude that their study is consistent with the hypothesis that insiders have access to non-public information related to the new issue on which they trade.

(d) Corporate dissolutions: Eyssell (1991) examined the share trading of insiders prior to two forms of corporate dissolution: bankruptcy and voluntary liquidation. The study was of 27 companies that filed for bankruptcy and 54 companies that went into voluntary liquidation. Prior research noted by the author found that there are different consequences for shareholder wealth (measured in terms of share returns) depending on the form of dissolution.

Eyssell observes that shareholders receive much more favourable returns when the company enters voluntary liquidation than when bankruptcy occurs. In fact, the studies generally show an increase in share price between the time that voluntary liquidation is first announced and its subsequent confirmation.

In the case of voluntary liquidation, insiders were generally purchasers of their company's shares. In contrast, insiders were heavy sellers in companies that eventually filed for bankruptcy.

Moreover, those insiders with the greatest access to information were the heaviest purchasers before liquidation announcements and the heaviest sellers before bankruptcy announcements. The author concludes that the "major findings suggest that at least some corporate insiders earned returns (or avoided losses) in a manner consistent with the exploitation of nonpublic information".

Canada: Lee and Bishara (1989) examined trading by insiders between 1980 and 1982 in the shares of 539 companies listed on the Toronto Stock Exchange. They found that insiders made abnormal profits by acquiring shares before an increase in the value of the shares. They also profited by selling shares before a decrease in the share price.

Britain: Pope, Morris and Peel (1990) examined 564 insider share trades in 1977-84 in companies listed on the London Stock Exchange for the period 1977 to 1984. As was the case with the other studies reviewed in this article, the evidence indicated that insiders acquired shares prior to price increases and sold shares prior to price decreases.

A cost-benefit perspective

The costs of a mandatory disclosure requirement must also be considered (Blair 1992).

These costs include:

- resources consumed by the government in developing rules;
- compliance costs; and
- resources consumed by the regulator (ASC and/or ASX) in processing the disclosure statements and enforcing the disclosure rules.

The costs will depend on the ambit of the disclosure requirement. For example, while it would be desirable to apply it to officers and not just directors, the need to limit the requirement to those officers who exercise a policy-making function was recognised by the United States SEC in its 1991 amendments to the s16 rules. Extending the requirement to the immediate family of insiders would also increase the costs.

Regulator pays

It should be noted that the bulk of the costs will be incurred by the regulator, although overseas precedents will assist in containing the resources consumed by the government in developing a disclosure regime. Compliance costs incurred by insiders and their companies should not be excessive, given that the insiders can be expected to be aware of their share dealings in their own companies.

If the requirement applied to members of the insider's immediate family sharing the same household (as is the case in the United States), the insider would also be expected to be aware of these persons' dealings in the shares of the insider's company.

Therefore, the main costs in this proposal will be the resources consumed by the regulator in reviewing and processing the disclosure statements and enforcing the disclosure rules. The task is to weigh these costs against the benefits of disclosure.

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