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An Insider Trading Loophole Congress Didn't Close

By Jack Hough

U.S. lawmakers will soon face the same explicit ban on profiting from inside information as other investors. The Senate on Thursday sent a bill saying as much to President Obama, and the president has said he will sign it.

That closes a loophole, but securities laws hold others.

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For example, corporate insiders whose companies are about to be bought by rivals are forbidden from buying shares ahead of time to profit from the price jumps that takeover announcements often bring. But they accumulate plenty of shares just the same, according to a study slated for publication in the Journal of Corporate Finance.

That's because company managers are often paid partly in stock. Many sell these shares at regular intervals, whether to use the cash for other purposes or to keep their personal assets from becoming too concentrated in a single stock.

For this reason, managers who decline to buy their companies' shares ahead of takeovers may nonetheless accumulate them if they also halt their typical selling. That's just what they seem to do.

Anup Agrawal of the University of Alabama and Tareque Nasser of Kansas State University studied 3,700 takeovers announced between 1988 and 2006. They compared trading in the year before takeover announcements (the "informed period") with the year before that (the "control period").

The two found that insiders tended to reduce their buying during the informed period, but they reduced their selling even more. The result was an increase in net buying. Over the six months prior to deal announcements, the dollar amount of net purchases for officers and directors at target firms rose 50%

relative to ordinary net purchase levels.

This “passive insider trading,” as the authors call it, is legal. But it is profitable? Messrs. Agrawal and Nasser didn’t look at returns, but a study published a year ago in the Journal of Multinational Financial Management offers clues.

Researchers from Australia’s Commonwealth Bank and Deakin University looked at U.S. takeovers between 2001 and 2006. They found that shares of target firms tended to outperform by nearly seven percentage points during the 50 trading days preceding deal announcements.

Don’t expect Congress to tackle this one soon. Regulation of insider trading is murky enough (see “Quiz: Is This Insider Trading?” and “Insider Trading: Legalize It?”). Rules for suspicious non-trading might create more problems than they solve.
