



Advance Disclosure of Managers' Stock Trades: A Proposal to Improve Executive Compensation

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The corporate scandals that erupted several years ago exposed major flaws in the executive compensation arrangements of public companies. One such flaw: boards permitted managers to sell shares on inside information. Managers made billions of dollars annually selling before “bad news.” In some cases, the bad news was that managers had been inflating the firm’s earnings.

Unfortunately, precious little has been done to deal with this problem. One simple step would be to require executives to announce

their intended trades several weeks in advance. The disclosure of unusual sell orders would intensify scrutiny of the firm. When investors believe the company is hiding bad news, the stock price would decline before managers sell, reducing their insider trading profits.

EXECUTIVES’ INSIDER TRADING

Stock options and restricted stock make up a large component of executive compensation. After their equity incentives vest, executives are generally free to sell the underlying stock. They are also usually free to decide when to unload these shares.

By using inside information to time their sales, executives can make large profits. Trading on “material” inside information is illegal. However, executives have access to many items

of inside information. Even when none of these items is sufficiently concrete and important to be considered legally “material,” knowing all these pieces of information and how they fit together enables managers to sell at the right time.

In addition, executives may not be deterred from trading on items of information that are “material.” The SEC, which is responsible for enforcing insider trading laws, has a relatively small enforcement budget. It focuses on the easy cases: trades immediately before “bombshell” announcements. Executives who trade on “material” inside information more than a month before the announcement date may escape detection and punishment.

There is considerable evidence that managers profitably use inside information to time their sales. For example, executives exercise their

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options and sell the underlying stock shortly before the stock underperforms the market, and sell heavily before earnings declines. Insiders also manipulate earnings to sell their own shares at higher prices, according to work by Daniel Bergstresser and Thomas Philippon, two scholars at the Harvard Business School, and Messod Beneish. My own calculations suggest that managers' private information enables them to make an extra several billion dollars annually selling their shares.

The recent corporate governance scandals provided dramatic examples of managerial insider trading. For example, Global Crossing's CEO sold more than \$700 million worth of shares in the year before the firm filed for bankruptcy. At the same time the company was inflating sales revenues. And Qwest Communications insiders sold more than \$2 billion while they were overstating revenues, shortly before Qwest stock fell more than 95 percent.

COSTS TO SHAREHOLDERS

Executives' ability to sell shares on inside information is likely to impose substantial costs on public shareholders. To begin, executive insider trading skims money from public

shareholders—perhaps several billion dollars each year—and puts it into the pockets of executives. One might argue that these profits are just another form of compensation. But insider trading profits are a very peculiar type of pay. They are tied to executives' informational advantage and their ability to manipulate earnings, not to their performance.

Moreover, insiders' ability to sell on bad news undermines the incentive effects of compensation arrangements. Huge executive compensation packages are justified as necessary to motivate managers to generate shareholder value. Permitting executives to sell on bad news reduces the financial payoff differential between good and poor performance, thereby undermining managers' incentive to increase shareholder value.

Executives free to unload shares also have an incentive to jack up the current stock price by running the firm in a way that improves short-term results at the expense of long-term value. In fact, managers' ability to sell shares increases the risk of all kinds of earnings manipulation, both legal and illegal. Such schemes impose real costs on shareholders. According to a 2004 study, firms that restated their financial statements following SEC allegations of accounting

fraud during the years 1996 to 2002 collectively paid an extra \$320 million in taxes after overstating their earnings so that managers could dump their shares at a higher price. The costs to shareholders of the distorted incentives caused by managers' ability to engage in insider trading may well exceed, by a large margin, the amount of value actually pocketed by managers.

BOARDS' ABDICATION

Both before and after the recent corporate scandals, boards could easily have taken steps to reduce executives' ability to sell on inside information, while still allowing executives to satisfy their legitimate liquidity and diversification needs. For example, boards could require that stock sales be carried out gradually in small increments over a specified period, according to a prearranged plan. Managers required to sell stock under such a plan could not easily exploit their access to inside information. They would also have less incentive to manipulate short-term earnings. However, boards have declined to take such steps.

Boards' failure to constrain executives' insider trading should not be surprising. Directors have had various reasons to go along with

arrangements favorable to the company's top executives, even if they are bad for shareholders. Executives' broad freedom to time stock sales certainly serves their own interests. It puts more money in their pockets. And, conveniently, managers' insider trading profits do not show up in any of the firm's publicly disclosed accounting results or compensation figures. So they go largely unnoticed by many investors in all but the most egregious cases.

AN ADVANCE DISCLOSURE RULE

Congress has so far done little to deal with the problem. Several provisions of the 2002 Sarbanes-Oxley Act are aimed at reducing managers' ability to profit by timing their trades. The most important requires executives to publicly report a trade by the end of the second business day following the transaction. Previously, executives had up to six weeks to report their trades. But after the fact disclosure, even when it is only two days after the fact, is hardly effective. The stock price might fall when a disclosed trade suggests there is hidden bad news. But that price change does not diminish the insider trading profits reaped by the executive two days earlier.

Instead of post-trading disclosure, why not require executives to disclose their intended trades several weeks in advance? The disclosure of large or otherwise unusual sale orders would intensify scrutiny of the firm and its managers. An unusually large sale order, for example, would signal the possibility that the executive knows bad news. If further investigation suggests that the stock is overpriced, market participants will drive the price down *before* the executive's sale is consummated, forcing the executive to trade at a worse price. The negative price adjustment, in turn, will reduce executives' ability to make a profit trading on inside information, as well as their incentive to manipulate earnings.

To be sure, when an executive sells on inside information, the price adjustment is unlikely to completely eliminate her insider trading profit from that trade. Public investors cannot be certain that the trade is information-driven. The executive could be selling for liquidity or diversification reasons. So when the insider trades on private information, the price adjustment may be too small.

However, when that same executive later makes a large or otherwise unusual sale for

liquidity or diversification reasons, public investors will suspect the trade is information-based, leading to a price adjustment that is too large. Such future "over-adjustments" will force the executive to give back to public investors more of her insider trading profits.

Currently, market professionals analyze insiders' post-transaction trading reports to identify executives whose purchases and sales predict large price movements. These executives' trades are used to figure out whether a particular stock is overpriced or underpriced. Managers with non-predictive trades attract far less attention. Under advance disclosure, we can expect executives who sell before large price declines to subsequently face larger adjustments than executives who do not.

What about "innocent" executives making routine liquidity or diversification sales for the first time? To avoid triggering an undeserved negative price adjustment, such executives can disaggregate and spread out their sales or commit to a fixed, gradual selling schedule far in advance of the first sale. These selling strategies make it more difficult for executives to profit from inside information. They also give insiders less incentive to manipulate earnings to

boost the short-term stock price. As a result, the market is unlikely to adjust the price against the executives when such sales are announced.

What could be wrong with advance disclosure? To be sure, many executives won't like it: they will need to work harder for their money. But isn't that just the point?

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