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Political Connections and the Informativeness of Insider Trades

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Extensive empirical literature examines the relation between managers' political connections and firm value. Most of this research suggests that these connections are associated with a wide range of benefits, including preferential access to capital and increased likelihood of winning government procurement contracts, and thus are generally valuable to shareholders. However, one missing aspect of this literature is whether (and how) corporate insiders use political connections to extract rents from shareholders. We look at one channel through which politically connected insiders might extract rents from shareholders—informed trading.

We examine the relation between political connections and informed trading by corporate insiders within the context of the 2007–2009 financial crisis. The unprecedented magnitude of government intervention during the financial crisis, the substantial impact of the intervention on firm value, and the political nature of the intervention provide a powerful setting in which to examine the relation between political connections and informed trading. It is now well known that (a) deliberations on government intervention took place largely in private meetings between government officials and insiders at leading financial institutions; (b) details regarding the application and qualification process for funds from the Troubled Asset Relief Program (TARP) were not publicly disclosed; and (c) political connections appear to have played a role in the allocation of these funds. Thus, politically connected insiders at leading financial institutions were in a position to be disproportionately privately informed about the scope of government intervention, how this intervention would affect their firm, and details of any forthcoming TARP monies.

We examine the relation between political connections and trading of corporate insiders using a comprehensive sample of all open market purchases and sales of Section 16 officers and directors (hereafter "insiders") at 497 publicly traded financial institutions ("banks") between 2005 and 2011. One advantage of focusing on the trading of corporate insiders (as opposed to the trading of other parties) is that it is relatively easy to obtain biographical data and work history from firms' proxy statements. Following prior research, we measure an insider's political connections on the basis of whether a board member has current or previous work experience at a bank regulator (e.g., the Federal Deposit Insurance Corporation, the Office of Thrift Supervision, or the Office of

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the Comptroller of the Currency), the Federal Reserve, the Department of the Treasury, or Congress, and we measure the informativeness of insider trades on the basis of their predictive ability for future performance.

Consistent with the notion that managers were unable to predict the effect of the forthcoming crisis on their firm, we find no evidence that insider trades predict future performance over the 24 months leading up to the crisis, or during the crisis before the creation of TARP (i.e., before October 2008). In contrast, over the 9 months *after* the creation of TARP (the period in which TARP funds were dispersed), we find that the predictive ability of insider trades for future performance is greater than during any other period in our sample. Both the predictive ability of insider purchases for *positive* future performance and the predictive ability of insider sales for *negative* future performance increase during this period.

Consistent with the increase in the informativeness of insider trades relating to private information gleaned from political connections, we find that the increase is concentrated entirely among the trades of politically connected insiders. Before the crisis, we find the difference in one-month-ahead future returns between purchases and sales of politically connected insiders is economically and statistically insignificant, -0.37 percent. However, during the period in which TARP funds were dispersed, the difference in one-month-ahead future returns between purchases and sales of politically connected insiders is both economically and statistically significant, 8.89 percent. These results are robust to a battery of sensitivity analyses, including controlling for time-invariant, firm-specific, and insider-specific characteristics; changes in market conditions; a differential effect of market conditions on firms with and without politically connected insiders; and measurement of returns over longer horizons.

Next, we use two distinct sets of tests to investigate whether the information advantage of politically connected insiders relates specifically to TARP capital infusions. In the first set of tests, we repeat our analyses after partitioning the sample on the basis of whether the firm received TARP funds. We find that the increase in the informativeness of insider trades during the crisis is concentrated among the trades of politically connected insiders at firms that received TARP funds, and we find no evidence of an increase in informativeness of insider trades among the trades of politically connected insiders at firms that did not receive TARP funds. This suggests that the information advantage is conditional on the bank being approved for TARP funds, and it relates to the details of the funding (e.g., timing or amount) rather than the probability of approval.

In the second set of tests, we use an event study to identify the relation between insider trades and the timing, amount, and market reaction to TARP infusions. Measuring trading by corporate insiders over the 30 days before the announcement of TARP capital infusions, we find that insiders are net buyers before 34.8 percent of infusions and net sellers before 20.3 percent of infusions in our sample. Moreover, we find that trades over the 30 days before the announcement predict both the amount of the infusion and the market reaction to the announcement—and that the predictive ability of these trades is concentrated among the trades of politically connected insiders. These results suggest that when politically connected insiders were net buyers before the announcement, the infusion was a large positive surprise to the market. Conversely, when insiders were net sellers before the announcement, the infusion was a large negative surprise to the market.

The results from our event-study analysis are consistent with politically connected insiders trading in anticipation of the surprise, and they are robust to a variety of sensitivity tests. Similar results are not observed among insiders without political connections, outside of the announcement period, in nonrecipients during the announcement period, or around other corporate events that are not directly related to TARP infusions (e.g., earnings announcements).

Collectively, our findings suggest that political connections provided corporate insiders with an important information advantage during the financial crisis, that a significant portion of this advantage related to knowledge about government intervention, and that some insiders traded to exploit this advantage.

NOTE:

This research brief is based on Alan D. Jagolinzer, David F. Larcker, Gaizka Ormazabal, and Daniel J. Taylor, "Political Connections and the Informativeness of Insider Trades," Rock Center for Corporate Governance at Stanford University Working Paper No. 222, September 2016, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2836053.