

INSIDER EARLY SALES IN IPO FIRMS

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ABSTRACT

The paper investigates the determinants of insider early sales (i.e., before the common lock-up expiration date) in IPO firms. We find that IPOs experiencing larger abnormal stock returns, with higher market-to-book (M/B) ratio, and backed by Venture Capitalists (VCs) are more likely to be involved in insider early sales. These results are consistent with the market timing hypothesis and liquidity need hypothesis. More importantly, consistent with strategic underpricing hypothesis, we find that magnitude of underpricing exerts a more statistically and economically significant influence on the insider early sales decision. Moreover, the relation is more pronounced for a group of insiders consisting of top management team only. We also find that the probability of insider early sales is positively associated with the underwriter reputation.

Keywords: *IPO, insider trading, underpricing*

1. INTRODUCTION

One of the most important decisions in business financing is the choice of initial public offering (IPO) – whether to go public or not. Going public is a big step forward for the privately held firms, and brings them many valuation-enhanced benefits (Pagano, Panetta, & Zingales, 1998). The proceeds from IPO can be used to finance profitable investment opportunities. An IPO can increase the transparency of the firm by subjecting it to the capital market regulations. Meanwhile, a public firm can easily raise additional proceeds through seasoned offerings. In addition, an IPO can provide a liquid market which allows pre-IPO corporate insiders (According to the filing requirements of Section 16 of the Exchange Act of 1934 and Section 403 of the Sarbanes-Oxley Act of 2002, insiders are defined as a company's directors, officers, and any beneficial owners of more than 10% of a class of the company's equity securities. In this paper, we use insiders and owner-manager interchangeably for IPO firms.), such as directors, officers, and large beneficial shareholders to exit their investment.

Specifically, around initial public offerings, corporate insiders have two opportunities to trade their shares: first, they can file their shares in the IPO prospectus and sell them as secondary shares at the time of IPO; secondly, they can sell or even purchase shares in the aftermarket. The filing about secondary shares shown in the IPO prospectus could draw higher attention from outside investors than aftermarket sales. Previous studies document that manager-owners usually do not sell any secondary shares in initial public offerings but instead sell their shares in the aftermarket (Aggarwal, Krigman, & Womack, 2002; HELWEGE, PIRINSKY, & STULZ, 2007).

Regarding IPO aftermarket insider trading, previous examinations mainly focus on the period around IPO lock-up expiration (Aggarwal et al., 2002; Field & Hanka, 2001). In the U.S., lockup provision is a voluntary agreement between corporate insiders and underwriters which prevents insiders from selling their shares for a specified length of time. 180 days is the dominant length of lockup period for U.S. IPOs (Bradley, Jordan, Yi, & Roten, 2001). The lockup provision imposes severe restrictions on the trading activities of firm insiders, because it usually prevents selling for six months. As mentioned above, previous studies generally investigate secondary share sales at the time of IPO and IPO aftermarket insider selling around the expiration of IPO lockups separately. However, little is known about insider trading activities beyond the short time window around the lockup expiration.

In this study we explicitly examine post-IPO insider trading activities by using data on 4,262 U.S. IPOs over the 1986 to 2010 period. Compared with numerous previous studies focusing on abnormal returns across