

# Trading around unscheduled announcements

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## Main Takeaway

Institutional investors are known to make efforts, both in terms of time and money, acquiring information through direct interactions with managers or through performing/ following fundamental analysis or accessing analysts' reports. An information-production role in the financial markets characterizes these investors. Theoretical research has shown that expected profit is necessary for investors to compensate for the efforts they put on information acquisition. However, the advent of algorithm trading (AT)/ HFT has put some brakes on institutions' incentives to acquire information. Academic research suggests that by reducing the informational rents of other traders, AT/HFT is responsible for dissuading information acquisition by them. For example, AT/HFT uses the so-called "back running" technique that follows the institutional traders' trades and eats into their profits. Thus, we already live in a world where institutions find it challenging to preserve their informational rents.

Under such a backdrop, we show that institutions have more reasons to worry about corporate insiders who have incentives to leak value-relevant information to the least informed traders. We chose the unscheduled corporate announcement events to document the same. Unscheduled announcements are characterized by an inherent suddenness, which surprises the

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market participants. These announcements include acquisitions, divestitures, equity offerings, buybacks, spin-offs, etc. In contrast to scheduled earnings announcements, where the announcements are known in advance, both the time and content of the announcements still need to be discovered for unscheduled announcements. Also, the nature of the unscheduled announcements is such that institutional investors cannot perform fundamental analysis and unearth the information in advance. For example, the immediate post-announcement returns after an equity offering or a buyback primarily depend on the offer price rather than on whether the firm has good fundamentals.

Thus, the institutions cannot become privy to the timing or the content of an impending unscheduled announcement. Hence, corporate insiders have an informational advantage in these announcements. Under such a circumstance, the insiders find it rational to leak a garbled version of the information to unrelated third parties. Two opposing effects operate on an insider's expected profit when (s)he voluntarily leaks information to unrelated parties. One, the apparent negative effect, leaking information to another trader, reduces the insider's informational advantage regarding the asset's fundamental value. The other is the positive effect: leaking information increases the insider's informational advantage regarding the execution price path of the asset relative to everyone else, as trades that rely on the leaked information make the asset price sensitive to the nonfundamental part (noise) of the leaked information. In a market where other informed traders (such as institutions) are present, the insiders increase their profits by leaking information to retail traders about events other informed traders are unaware of (such as unscheduled announcements). The insiders win, and the retail traders (or the least informed traders) also win at the expense of the other informed traders.

**Period of the study and the sample:**

We use the rich and clean trade-level data from the National Stock Exchange of India. The exchange flags the data, and thus, we can identify whether the trades are coming from retail, HFT, or institutions. Our sample of stocks are the 500 constituent stocks of the index NIFTY500, and the study period is five years, from 2011 to 2015. We find 1491 unscheduled announcements in this period for the 500 stocks and the announcements were collected from Bloomberg. Almost two-thirds of the announcements are “Acquisitions” or “Divestitures.” Moreover, the rest are divided between “Equity Offerings,” “Buybacks,” “Joint Ventures,” and “Spin-Offs.”

**Methodology:**

We use portfolio sorting methodology, something which is common in literature. For each of the 1491 events, we observe the trading behavior of each of the groups of traders for up to five days before, i.e., for days  $T - 5$  to  $T - 1$  (day  $T$  being the announcement day). Specifically, we compute a trading imbalance measure that subtracts the number of shares sold from the number bought by the trading group in these five days. If a group bought many more shares than they sold, we will find the measure highly positive.

We then try to see how the imbalance measure for each group is related to immediate post-announcement stock returns (of days  $T$  to  $T + 1$ ). If any group is privy to the information ahead of the announcements, then we should expect their trading imbalance measure to be positively associated with the post-announcement returns.

For each trading group, we note the imbalance measure for the 1491 events and then sort them and divide them into four quintiles (Q1, Q2, Q3, and Q4), with Q1 being the collection of

unscheduled announcement events in which the stock in question has been sold the most (in days  $T - 5$  to  $T - 1$ ) by the trading group. Similarly, Q4 is the collection of events in which the group has bought the stock the most. We then note the difference in the average post-announcement returns for the events in Q4 and Q1. If the difference is significantly positive, it means that the stocks the group purchased the most (prior to the announcement) have had more good news announcements than the stocks the group sold the most. In short, on average, the group was privy to the news ahead of the announcements.

We compute the measures for all the trading groups and find that only retail traders showed positive and significant differences between Q4 and Q1. We do not find this result for HFT and the institutions, the standard well-known informed group of traders. All these point to the fact that for unscheduled announcements, the retail traders are privy to the content of the news ahead of the announcements, whereas the other informed traders are not.

In parallel, we also find the retail traders to be the least informed traders when we consider the trading profits computed for all stocks and days (500 stocks and five years). They stack up significantly negative profits throughout the sample period. Meanwhile, the HFT and the institutions stack up positive profits. Additionally, when we consider the scheduled earnings announcements, we find that retail traders are not informed, whereas HFT and the institutions are. It is not surprising, as institutions are known to conduct fundamental analysis themselves and spend resources to gather fundamental information about impending earnings announcements.

We find the retail traders to be uninformed in every respect except for the unscheduled corporate announcements. Considering all these results together, one can conclude that retail traders are the beneficiaries of information leakage in case of unscheduled announcements.

### **Mechanism of the leakage:**

How is it possible that insiders can leak information to the least informed traders, completely bypassing the other informed traders? One possible avenue is the bulk short message service to mobile phones (SMS). Before 2016, it was common to see individuals with trading accounts receiving unsolicited trading tips. In fact, at times, it used to come from the official brokerage house. Only in 2016 did the capital market regulator SEBI come out publicly against these unsolicited trading tips on phones and proposed a ban. Thus, before 2016, it was possible for an insider who wanted to leak information to individual traders only to do so easily with some help from the stock broking house. The broking houses did not worry as it was not illegal to do so.

Social media is another mechanism that can help spread leaked information among retail investors. Academic literature suggests that information shared through social media has helped retail traders improve their trading performance. Several social media websites provide platforms for debating investment strategies and sharing investment research. Retail investors have also used social media to “gang up” by spurring each other on various platforms (Reddit, Twitter, YouTube, etc.), at times irrationally, to trade in one direction of the market.

Thus, it is also possible that the insider leaks the news (about unscheduled announcements) to some retail traders through some social media closed club (say a WhatsApp group), and then few members share that information with other groups or chatrooms they are part of and with a cascading effect the news spreads in rapid time to a significant proportion of the retail trading group.