When chasing the offender hurts the victim: The case of insider legislation

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ABSTRACT

Backers and opponents argue over the pros and cons of legislation forbidding trading by informed insiders. Yet a lack of reliable empirical data about the effects of such legislation inhibits a conclusive scientific evaluation. We overcome this problem by resorting to laboratory markets and find that insider legislation has significant negative effects on multiple market dimensions: under insider legislation, (1) markets are less liquid, (2) markets are less informationally efficient, and (3) uninformed traders’ earnings (before redistribution of illicit insider gains) are lower.

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1. Introduction

Ever since the emergence of insider trading [see Bhattacharya and Daouk (2002), for a historical review] backers and opponents have argued over pros and cons and consequently whether insider trading should be regulated or not.1 Advocates of strict regulation highlight the negative effects of insider trading on investor confidence and the attendant negative effects on market participation. They point to the potential harm that reduced participation in securities markets causes the overall economy and contend that adverse selection risk leads to larger spreads (Bagehot, 1971) and lower price efficiency (Fishman and Hagerty, 1992). Opponents of regulation argue that insider trading helps increase price efficiency because it moves prices in the direction the price would be if more information were public. In this view, earnings gained by insiders are the legitimate compensation for generating and revealing relevant new information about the firm. Following this argument, insiders’ profits are the price society pays for obtaining the beneficial effects of enhanced price efficiency. See Bainbridge (2013) for a review of the arguments and recent studies.

From a scientific perspective, studies on insider trading legislation, its consequences for trader behavior, and the aggregate effects on markets are complicated by a major obstacle. The prevailing legal systems prohibit insider trading and thus preclude empirical analyses due to a lack of data [see Meulbroek (1992) for a rare counterexample]. In particular, it is impossible to analyze otherwise identical markets once under a regime with and once under a regime without insider trading legislation. Furthermore, any such analysis would have to be insulated against the noise of general market events. To avoid this caveat restricting classical empirical research, we study the effects of insider trading legislation using data from laboratory asset markets.2

In a laboratory experimental setting, we are not only able to observe every aspect of traders’ behavior, we also control the market environment. Varying only variables of particular interest (i.e., the intensity of insider competition and whether or not there are rules against insider trading) we can isolate the effects of insider legislation on trader behavior, profits, and market efficiency in different environments.3

We structure our analysis along three dimensions. First, we explore whether and how informed traders adapt their trading behavior in response to insider trading legislation. There is evidence that insiders exhibit abnormally high trading activity (Easley and O’Hara, 1987; Meulbroek, 1992). So far, however, there is no evidence on how these findings differ between markets with and without insider legislation. Imposing prosecution risk on insiders changes their economic environment, presumably triggering a behavioral response. Economically speaking, prosecution and fines increase insiders’ cost of trading.4 This increase in expected marginal cost has at least two consequences. First, we expect informed traders to refrain from conducting transactions for which the marginal benefits are lower than the increased marginal costs, causing an overall decrease in market liquidity. Second, we expect informed traders to camouflage their presence by adapting their trading behavior in order to avoid prosecution (Medrano and Vives, 2001; Schnitzlein, 2002; Chakraborty and Yilmaz, 2004; Hornung, Leopold-Wildburger, Mestel and Palan, 2015).

The second dimension we study is the effect of insider trading legislation on measures of market quality like the informational efficiency of prices, bid–ask spreads, and volatility. The analysis of price efficiency lies at the heart of the economic reasoning against any sort of insider trading legislation.

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1 The U.S. Securities and Exchange Commission (SEC) defines illegal insider trading as trading in securities, in breach of a fiduciary duty or other relationship of trust and confidence, while in possession of material, non-public information about the security. See http://www.sec.gov/answers/insider.htm for further information.
2 Experimental asset market research has seen strong growth over the last three decades, including several papers published in top finance journals. Examples include Gneezy, Kapteyn and Potters (2003), Haruvy and Noussair (2006), Bhojraj, Bloomfield and William (2009), and Bossaerts, Ghirardato, Guarnaschelli and Zame (2010). Noussair and Tucker (2013) and Palan (2013) provide recent reviews of experimental research on asset markets.
3 For example, see Nöth and Weber (1996), Schnitzlein (1996), Schnitzlein (2002), Barner, Feri and Plott Charles (2005), Bloomfield, Maureen and Saar (2005), Kirchler (2009), and Stöckl and Kirchler (2014) for experimental studies focusing on different aspects of markets populated by asymmetrically informed traders.
4 See Becker (1968) for a theoretical analysis of crime and punishment and Aitken, Cumming and Feng (2015) for related empirical work.
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