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Insider trading, abnormal return and preferential information: Supervising through a probabilistic model

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Abstract

The enforcement of the ban on insider trading requires an evaluation of the disgorgement, i.e. the capital gain of the insider trader who takes advantage of the exploitation of preferential information. An initial step forward on this topic has been taken by the SEC, the United States Securities and Exchange Commission, which has developed a quantitative procedure based on the event-study methodology. This paper develops an adaptation of this procedure for the Italian market and explains the limits of these methodologies in the analysis of the insider-trading phenomenon. In particular, it emerges that the econometric approach cannot be applied to all insider-trading schemes. In fact, in order to work out statistically significant results, it relies on a series of assumptions such as the existence of a robust reference market index or the availability of long time series data. For this reason, a new procedure for computing the economic value of the information exploited by the insider, based on a probabilistic approach, has also been developed. This methodology overcomes the issues connected to the event-study procedure and can be applied by construction to all insider-trading schemes and not only to the simplest ones. In fact, the model parameters are defined by using the trading strategy of the single insider; thus, if insider trading takes place, the model is able to offer a disgorgement computation; hence, by hypotheses of its construction, it is able to detect the difference between insiders and followers. The new procedure has been adopted by CONSOB and has been presented to the Judicial System, which is in charge of inflicting the fine.
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1. Introduction

If the market is a public good, the exploitation of preferential information in fraud of other investors is a damage inflicted to the financial system itself. The enforcement of the ban on insider trading increases the trust in the market and encourage the investors in trading. The role of supervisors is to prevent these kind of damages by defining a regulation which is modern, effective, accepted and respected by the players of the system. The loss of respect must be enforced and the repression in these circumstances is required.

On a worldwide scale, of a total of 103 countries that have stock markets, 87 of them have regulated the insider-trading phenomenon (Bhattacharya and Daouk, 2000). This situation is the result of a dispute between the two main theoretical streams, which can be succinctly represented as follows: the first is convinced that a ban on insider trading reduces market efficiency and managers' compensation, while the other states that the insider trader appropriates the value of the preferential information to the detriment of other investors and consequently the repression of this crime increases the investors' trust in the market, and hence its liquidity. These theoretical streams have developed their arguments in more than 250 papers over the last forty years. These arguments can be summarized in three theories in favor of the repression of insider trading and three others against it (Bainbridge, 1998).

The three theories against the enforcement of a ban on insider trading can be defined as follows:

1. victimless crime,
2. managers' compensation,
3. market efficiency.

The first one (Herzel and Katz, 1987) [1] states that insider trading has no victim; this is because transactions carried out by the insider moves the stock price in the same direction as preferential information and consequently the counterpart of the insider also takes advantage of the insider's transactions. For instance, in the case of bullish information the insider would raise the stock price and consequently the counterpart would sell the stock at a higher price than he would have without the insider transactions.

The second theory is based on the concept that the only effective way to compensate managers is through the exploitation of preferential information. This is because of the fact that bonus and stock options are not flexible enough and financially viable for the company (Manne, 1966).

The latest theory against the regulation of the crime exploits the concept of market efficiency in its strong form, i.e. the stock price reflects all available information, preferential included. Hence, by carrying out his strategy, the insider pushes the

[1] The view that insider trading is a "victimless crime" is a popular one. Hertzel and Katz, in their paper explain this theory and criticize it.

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