The effects of insider trading on liquidity

Louis Cheng a,⁎, Michael Firth a, T.Y. Leung b, Oliver Rui c

a School of Accounting and Finance, The Hong Kong Polytechnic University, Hung Hom, Hong Kong
b Department of Accountancy, The City University of Hong Kong, Hong Kong
c Faculty of Business Administration, The Chinese University of Hong Kong, Hong Kong

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Abstract

This study examines the impacts of directors’ dealings on firm liquidity. Consistent with the information asymmetry hypothesis, spread widens and depth falls on insider trading days as compared to non-insider trading days. This result suggests that increased share trading by insiders impairs liquidity. In addition, the spread (depth) measures are positively (negatively) related to how heavily the shares are transacted by informed traders; that is, the greater the number of shares traded by the directors, the wider (narrower) the spread (depth).

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1. Introduction

The impact of informed trading on liquidity behavior has been an empirical issue in both the insider trading and liquidity literature. Whether the insiders use their inside information to time the market and whether the market can detect and then protect against the presence of informed trading by adjusting its liquidity costs has aroused the attention of academics, policy-makers, practitioners and outside investors. The positive and negative changes in market liquidity due to informed trading have informed the debate on whether insider trading should be allowed in order to speed up information transmission or strictly prohibited in order to create an equitable playing field in the securities market. Therefore, it is an interesting empirical question to examine whether informed trading has favorable or unfavorable impacts on market liquidity.

⁎ Corresponding author. Tel.: +852 2766 7140; fax: +852 2356 9550.
E-mail address: aflcheng@inet.polyu.edu.hk (L. Cheng).

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The “information model” theory hypothesizes that as the information disparity between insiders and outsiders widens, a share’s spread and depth will be adjusted to reflect the changes in the liquidity cost and trading activity. One of the issues in the liquidity literature is whether the informed trading enhances or reduces market liquidity (spread and depth). Many studies (Copeland and Galai, 1983; Glosten and Milgrom, 1985; Kyle, 1985; Easley and O’Hara, 1987; Foster and Viswanathan, 1990) have shown that greater information asymmetry between informed and uninformed traders leads to wider spreads and narrower depth. However, there are some other studies arguing that increased information disclosure through insider trading should enhance liquidity (Admati and Pfleiderer, 1991; Pagano and Röell, 1996; Harris and Schultz, 1997; Brennan and Tamarowski, 2000; Cao et al., 2004).

This study uses directors’ dealings (informed trading at the individual-level) to explore the impact of informed trading on liquidity in the Hong Kong securities market. We provide evidence to support the information asymmetry hypothesis that market liquidity is affected by the presence of informed trading, i.e., directors’ transactions in our study, in the market. Spread (absolute spread and relative spread) increases and depth (volume depth, dollar depth, ask depth and bid depth) decreases on insider trading days. The increase in liquidity cost due to insider trading is still significant even after controlling for volume, price and volatility. There is no difference in the liquidity patterns between informed buy-initiated and sell-initiated orders. In addition, we find that liquidity costs are affected by how heavily the shares are traded by the directors. Spread (depth) increases (decreases) with the trading activity of directors. We provide further evidence that insider trading volume is positively related to spread and negatively related to depth; insider trading volume is therefore negatively related to liquidity.

Our paper proceeds as follows. Section 2 presents the literature review and theoretical background. Data and methodology are described in Section 3. Section 4 reports the empirical results. Section 5 concludes the study.

2. Literature review and theoretical background

The information asymmetry model of market microstructure suggests that the greater the extent of information asymmetry between informed and uninformed traders, the wider the spread and the narrower the depth. Insiders possess confidential information about the true value of the firms that the outsiders do not have. When the market suspects the presence of insider trading activity, the spread, depth and adverse selection cost are adjusted. In order to examine whether market liquidity is affected favorably or unfavorably in the presence of informed trading, many empirical studies have been conducted to test directly the impact of share repurchase and insider trading on the bid-ask spread and market depth (Barclay and Smith, 1988; Cornell and Sirri, 1992; Singh et al., 1994; Wiggins, 1994; Franz et al., 1995; Miller and McConnell, 1995; Chung and Charoenwong, 1998; Bettis et al., 2000; Charoenwong and Chung, 2000; Brockman and Chung, 2001; Cao et al., 2004). However, mixed results have been reported. For example, Barclay and Smith (1988) find that firms making share repurchase announcements have wider relative spreads in the year following the repurchase announcements. In contrast, Singh et al. (1994) and Miller and McConnell (1995) report no increase in spread surrounding open-market share repurchase announcements.

Chung and Charoenwong (1998) and Charoenwong and Chung (2000) examine the relations between insider trading and spread and depth. They find no evidence of significant
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