International Review of Law and Economics 25 (2005) 169–185

International Review of Law and Economics

The Information Content of Registered Insider Trading Under Lax Law Enforcement☆

Tomasz P. Wisniewski, Martin T. Bohl *

Department of Economics, European University Viadrina Frankfurt (Oder), Große Scharrnstraße 59, 15230 Frankfurt (Oder), Germany

Abstract

With the use of event study methodology, this paper examines abnormal returns following insider trading on the Warsaw Stock Exchange (WSE). The profits to informed investors appear to be substantially higher than estimates reported for mature markets. It is our contention that these profits are a manifestation of insufficient enforcement of insider trading regulations. To explore the origins of informational asymmetries we relate insider gains to firm and trade characteristics. As changes in shareholdings have to be disclosed promptly and the informational content of the insiders' trades is not instantly discounted in stock prices, outsiders who mimic the insiders' behavior are able to beat a benchmark portfolio.

JEL classification: G14; G18; K22

Keywords: Insider trading; Market efficiency; Transaction data; Polish stock market

1. Introduction

Corporate officers and directors are frequently in a position to have special knowledge of the affairs of their company. Some of the information at their disposal could be undisclosed

☆ Constructive comments were received from Emmanuel Pikoulakis, Shauna Selvarajah, participants of a seminar at the European University Viadrina, Invest 2002 conference, Global Finance Conference 2003 and two anonymous referees.
* Corresponding author. Tel.: +49 335 5534 2984; fax: +49 335 5535 2959.
E-mail address: bohl@euv-frankfurt-o.de (M.T. Bohl).

0144-8188/$ – see front matter
doi:10.1016/j.irle.2005.06.002

and hence not yet discounted in stock prices. Having the prescience of events that are about to unfold or be reported, insiders are faced with temptation to exploit the informational asymmetries by trading profitably. On the other hand, the fear of potential litigation and adverse publicity may restrict insider gains.

Insider trading prohibitions and the commitment to implement existing legislation has generated a great deal of controversy. Contrary to prevalent beliefs and intuition, the academic literature seems to indicate that there is little, if any, relationship between the restrictiveness of regulation and insiders' opportunistic behavior (Banerjee & Eckard, 2001; Jaffe, 1974a; Seyhun, 1992a). What de facto matters to an agent who trades on the basis of his or her superior private information is the level of law enforcement (Bhattacharya & Daouk, 2002). The optimal enforcement of insider trading sanctions under nonzero investigation costs, however, is essentially a non-trivial issue. DeMarzo, Fishman, and Hagerty (1998) show that the policy that maximises investors' welfare is one that permits a limited amount of insider trading, but if its volume exceeds a certain nonrandom threshold the maximum feasible penalty should be imposed.

This paper attempts to augment the scanty empirical evidence on the impact of law enforcement. This is done by evaluating the magnitude of excess profits to insiders in Poland who trade in a state of impunity. On the whole, the research into the issue of insider trading in emerging markets is severely limited due to the scarcity of available data. At the same time, the extant evidence indicates that trading on privileged information in markets with law enforcement deficiency is the rule rather than the exception (Bhattacharya et al., 2000), which is why our inferences could be of valuable assistance to surveillance and law enforcement divisions.

The Law on the Public Trading of Securities of 1997 specifies the civil and penal liability for exploiting material nonpublic information (Art. 176 section 2): "Whosoever in securities trading uses inside information shall be subject to a fine of up to 5,000,000 PLN and imprisonment from 6 months to 5 years". Furthermore, some of the enterprises listed on the Warsaw Stock Exchange (WSE) set their own insider trading policies through employment contracts.[1] In the 12-year history of the WSE, the Polish Securities and Exchange Commission (SEC) forwarded to the public prosecutor 49 notifications on suspicion of breaching the aforementioned Art. 176. Nevertheless, in cases where prosecution follows, the effectiveness of the legal proceedings could be called into question. Merely one sentence has been passed on charges of insider trading; 1 year of imprisonment with a suspension of 2 years.

At times, the impasse in the enforcement of existing provisions generates heated polemics in the public domain. For instance, in her press interview,[2] a prosecuting attorney from the Warsaw District Public Prosecutor's Office stated that one should not overemphasize the importance of securities law violations, as compared to other types of economic crime. As she put it: "Polish capital market is still in its infancy and only a small fraction of society is interested in its development". She further admitted that cooperation with the SEC is not frictionless and many differences of opinion remain. Following her interview, the SEC

[1] Bettis, Coles, and Lemmon (2001) and Kucinski (2000) discuss various trading and corporate policies restricting trading by insiders.

[2] "Co Prokuratura sadzi o Problemie Przestepstw na GPW", *Parkiet* 9 Dec. 2002.