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Disclosure regulation and the profitability of insider trading: Evidence from New Zealand

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Abstract

This paper provides evidence on insider trading in New Zealand by examining transactions disclosed by corporate insiders for a sample of 93 listed companies over the 1995–2001 period. These transactions include two types of disclosures: immediate disclosures, as represented by substantial shareholder (SSH) notices, and delayed disclosures, as reported in annual reports. The results (2453 transactions) show that insiders earn significantly large abnormal returns on their transactions, with the gains coming largely from transactions involving delayed disclosure. In contrast, transactions involving immediate disclosure earn insignificant returns. The results also show that the size of the company, membership in a major stock index, the position of the insider and the percentage of the insider's holdings being traded all affect the size of the abnormal returns. These findings lend strong support to amendments to securities laws that require continuous disclosure for all transactions.

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1. Introduction

Insider trading can be defined as trading by people with information superior to that possessed by the market. Typically, insiders are company directors, executives and large shareholders. In most countries, insiders are required to disclose their trading to the appropriate government agencies, such as the Securities and Exchange Commission in

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the U.S., within a reasonably short period of time following the date of the transaction. The details of insiders' transactions are then made available to the public through various media. This information receives a great deal of attention by investors and the press due to the perception that insider trades are driven by information asymmetry. Other parties privy to information include relatives of corporate insiders and constructive insiders such as lawyers and accountants of the company who acquire their information due to their contractual relationships with the company. Transactions by these parties are less widely followed by the market because of greater difficulty in obtaining information about the trades.

The profitability of insider trading has been the subject of numerous studies. In general, these studies show that insiders are better informed about their companies' prospects and that they trade profitably based on this information. For example, Lorie and Niederhoffer (1968), Jaffe (1974), Finnerty (1976) and Seyhun (1992), among others, show that insiders in the U.S. make abnormally large returns from their trades. Pope et al. (1990) and Friederich et al. (2002) examine insider trading in the U.K. market and report similarly large abnormal results. These studies report consistently significant results for purchases and conclude that purchases are more informative than sales. While there are a number of reasons to sell a stock, including liquidity needs and portfolio rebalancing, the main reason for buying stocks is profit (Jeng et al., 1999; Carpenter and Remmers, 2001; Friederich et al., 2002).

There is also evidence showing that insiders can successfully time their transactions. That is, insiders buy shares after a decline in the price that is followed by price increases and sell shares after a price run-up, which then reverses and results in negative returns (Lakonishok and Lee, 2001). However, there is mixed evidence whether or not outsiders can profitably mimic insider transactions. Seyhun (1986) and Rozeff and Zaman (1988) found that outsiders following insider trades could not earn abnormal returns. In contrast, examining a sample of trades with a relatively shorter delay between trade and disclosure, Bettis and Vickey (1997) found that both insiders and outsiders could make significant abnormal profits based on purchases and sales over both short and long holding periods. Bettis and Vickey (1997) showed that, even after adjusting for transaction costs, outsiders could still make abnormal gains by simulating insider transactions.

Despite the weight of evidence that insiders can earn abnormal returns, a small number of studies have found evidence to the contrary. Rozeff and Zaman (1988) found that, once transaction costs of 2% were taken into account, insiders in the U.S. market could not earn significant returns. For the Oslo Stock Exchange, Eckbo and Smith (1998) failed to find abnormal returns due to insider trading. Surprisingly, this study showed that insiders as a group underperformed professionally managed funds.

Insider trading has been the subject of very little research in New Zealand. Studies of insider trading are restricted to Etebari and Duncan (1997) and Duncan and Etebari (1990), who studied insider trading in the years 1986 and 1993. Both studies analyzed price run-ups prior to corporate announcements and reported evidence of potential insider trading in New Zealand. Casey and Tourani-Rad (2001) examined data on directors' trades disclosed in annual reports for the period 1993–1999. They showed that insiders could obtain 15.63% abnormal returns when they purchased but suffered a loss of 11.75% when they sold shares. This finding partly supports the evidence from other markets, with positive returns to purchases. However, the treatment of sales and the size of the purchaser's profits are vastly different to those recorded in these markets.