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Insider trading under trading ban regulation in China's A-share market☆

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ABSTRACT

This study examines the effects of China's 2008 trading ban regulation on the insider trading of large shareholders in China's A-share market. It finds no evidence of insider trading during the ban period (one month before the announcement of a financial report), due to high regulation risk. However, the ban only constrains the profitability of insider trades during the ban period, while trades outside it remain highly profitable. Informed insider trading before the ban period is 2.83 times more profitable than uninformed trading. The regulation has changed insider trading patterns, but has been ineffective in preventing insider trading by large shareholders due to rigid administrative supervision and a lack of civil litigation and flexible market monitoring. This study enhances understanding of large shareholders' trading behavior and has important implications for regulators.

1. Introduction

When China's A-share market was initially established, it comprised two types of stocks, tradable and non-tradable. Stocks owned by large shareholders and executives were mostly non-tradable and could not be traded in the secondary market. This issue of market segmentation between tradable and non-tradable

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stocks was resolved at the end of 2005 with the A-share market reform. To mitigate the supply pressure on the secondary market resulting from this change, the Chinese Securities Regulatory Commission (CSRC) established a lockup period of one to three years so that the non-tradable stocks could not be sold immediately. Since the beginning of 2007, the locked-up stocks have gradually become tradable. By the end of 2011, almost all of the non-tradable shares had become tradable, with insider trades happening more frequently. According to the Wind Database, during the 2007–2012 period, there were 24,152 executive transactions and 10,059 large shareholder transactions. Insider trades began to profoundly affect the stock market's development. However, due to the lack of a sound transaction monitoring system and mechanisms to protect investors' interests, insider trading became prominent in the A-share market. The current fight against insider trading is facing serious challenges. How to improve the effectiveness of insider trading regulation under the new circumstances is not only an important academic research issue, but also a regulatory challenge.

Earnings announcements are listed companies' most important periodic announcement. Information asymmetry between insiders and outsiders is amplified around the earnings announcement period, as it provides stronger incentives for insiders to use earnings information to trade. To keep insiders from trading on earnings information, most countries have implemented a mandatory regulation prohibiting insiders from trading during a short period before earnings announcements—often referred to as the trading ban regulation. In the United Kingdom, as early as 1977, regulators began prohibiting insider trading two months before an earnings announcement. In the United States, while there is no mandatory insider trading ban regulation, increased litigation risk has prompted many large companies to voluntarily implement trading ban policies. The Hong Kong Stock Exchange announced a new rule extending the board of directors' trading ban period from 30 to 60 days before the year-end earnings announcement on February 12, 2009. More than 200 listed companies jointly opposed the amendment and the event became the market's worst fight against the regulatory body since the 2002 "penny stock incident." However, as the Hong Kong Stock Exchange notes, other regulations such as penalties for insider trading often take years of investigation and have little success. In comparison, the trading ban regulation has eliminated trading opportunities during a period within which insiders are most likely to possess an information advantage. This regulation can effectively minimize the occurrence of insider trading, and thus has become a very useful tool for the regulators in restraining insider trading.

The CSRC enacted trading ban regulations on executives and large shareholders' trades in April 2007 and April 2008, respectively. The regulations prohibit executives from trading 10 days before earnings preannouncements and 30 days before the formal financial report is issued. In addition, large shareholders with more than 30% of shares are prohibited from purchasing 10 days before earnings preannouncements and 10 days before the formal financial report is issued. They are also prohibited from selling 30 days before the semi-annual and annual financial reports. Would insiders give up the chance to profit on earnings information under the trading ban regulation? Media reports on insider trading around the ban period are plentiful. For example, the chairman of Bishengyuan significantly reduced his holdings right before the trading ban period of the 2012 annual report, as the company was expected to have losses in 2012 and 2013, causing the stock price to drop 35% within 3 days. Faced with the trading ban regulation, insiders may adjust how they trade and conceal informative trading activities. What is the new insider trading pattern under the ban regulation? The game between insiders and regulators creates uncertainty regarding the regulation's effectiveness, but can a trading ban regulation effectively reduce insider trading profitability?

Table 1
Trading ban regulations.

Type of insider	Market	Earnings preannouncements	Annual and semi-annual financial reports	Quarterly financial reports
Directors, Supervisors, Managers (Executives)	Main board and SME board	Cannot buy or sell 10 days before	Cannot buy or sell 30 days before	Cannot buy or sell 30 days before
Largest shareholder $\geqslant 30\%$ and ultimate controlling owner	Main board	Cannot buy 10 days before	Cannot buy 10 days before; cannot sell 30 days before	Cannot buy 10 days before
Largest shareholder $\geqslant 30\%$ and ultimate controlling owner	SME board	Cannot buy or sell 10 days before	Cannot buy or sell 15 days before	Cannot buy or sell 15 days before