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An investigation of insider trading profits in the Spanish stock market

Esther B. Del Brio[a,*], Alberto Miguel[a], Javier Perote[b]

[a]*Dpt. Analisis Economico y Contabilidad, Universidad de Salamanca, Campus Miguel de Unamuno, 37007 Salamanca, Spain*

[b]*Dpt. Economia e Historia Economica, Universidad de Salamanca, Campus Miguel de Unamuno, 37007 Salamanca, Spain*

Abstract

This paper investigates the profitability and information content of insider trading in the Spanish stock market. Our results show that insiders earn excess profits when investing on corporate nonpublic information, while outsiders mimicking them fail to obtain those excess returns. The paper also investigates the relevance of a third party investing on the insider's behalf. The study further focuses on some methodological aspects, such as the need to take estimation periods that are not affected by other events or by other prediction periods, and the need to allow volatility during insider trading events to have interday memory. © 2002 Board of Trustees of the University of Illinois. All rights reserved.

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1. Introduction

Insider trading literature focuses on the examination of insiders trading on material, nonpublic corporate information, so as to gauge whether insiders earn larger profits than those they would obtain if they traded on the available public-information set. The rationale of this research lies in the debate over whether insider transactions produce more informative

* Corresponding author. Tel.: +34-923-294640.

E-mail address: ebrio@gugu.usal.es (E.B. Del Brio).

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security prices, fostering market efficiency, or whether these large profits point on the contrary to the inefficiency of capital markets. Furthermore, research on insider trading also attempts to ascertain the extent to which noninsiders could achieve the excess returns earned by insiders. Previous papers have produced contradictory evidence regarding the profitability of insiders and the social effects of insider trading. Kerr (1980), Lin and Howe (1990) and Holderness and Sheehan (1985) support strong-form efficiency, while Jaffe (1974a), Seyhun (1986, 1988a) or Madura and Wiant (1995) identify abnormal performance attributable to insiders; some of the latter papers also produce evidence against the semistrong form of the efficient market hypothesis (hereafter EMH). However, the literature on insider trading mainly supports the view that while insiders manage to outperform the market, outsiders cannot obtain excess returns by merely imitating insiders' transactions.

The research on insider trading has been confined to a small number of financial markets. In addition to U.S. markets, studies on insider trading have been performed for the Canadian and Mexican stock markets (Baesel and Stein, 1989 and Bhattacharya et al. 2000, respectively) and, in Europe, only for the Oslo Stock Exchange (Eckbo and Smith, 1998) and the London Stock Exchange (Pope et al., 1990). Our research uses Spanish stock market data for the first time to examine the debate on the profitability and information content of insider trading and its benefits and drawbacks.

Insider trading is illegal in Spain. Under the assumption that the drawbacks of insider trading outweigh its benefits, both company and security market laws are designed to prosecute and penalize the use of private information by corporate insiders. Though more recent and less developed than U.S. rules, the comprehensive Spanish legislation on insider trading does promulgate the disclose-or-refrain rule. It is telling, however, that there is, no record of insider trading having been prosecuted in recent decades. That may cast doubts on the effectiveness of these laws, raising the question of whether insiders may be encouraged to invest on the basis of their private information.

There is little literature on the use of private information in Spanish stock markets. As a result, it is quite difficult to anticipate how insider trading may be affecting market efficiency.[1] Spanish markets are in need of a comprehensive research on the investment behavior of informed traders. With regard to the market microstructure literature, only a few papers such as Tapia (1996) and Rubio and Tapia (1996), analyze trading behavior in an asymmetric-information setting, suggesting that informed investors usually benefit from their trading. In the context of the event study methodology, Ocaña et al. (1997) and Del Brio et al. (2000) also suggest that insiders may be exploiting their private information. Taking a sample of take-overs and investment announcements, respectively, both detect that the market reacts during the preannouncement period, which may be attributable to the presence of private information in the market. However, in neither case are data on insider trades used. Another relevant but unexplored aspect of insider trading in Spanish markets is the debate on the desirability of the legalization of insider trading. As far as we know, only the legal literature on insider trading has focused on this issue.

From the foregoing it may be readily concluded that this paper has a big gap to fill. Firstly, it should yield conclusions as to the profitability and information content of insider trading in the Spanish market, since this has never been done before. Secondly, in view of the results, and bearing in mind that insider trading is prohibited under Spanish laws, the paper should