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Modelling the information content in insider trades in the Singapore exchange

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Abstract

Over the past decade, numerous studies have debated the usefulness of insider trading. One particularly important study relates to the informational role that insiders' transaction volumes have on trading activity in the equity market. In our paper, we examine whether insiders' purchases (sales) indicate positive (negative) earnings announcements. We argue that if insiders have early access to publicly announced information, then the issuance of good (bad) news should be preceded by insider buying (selling) activities. The results reveal that insiders' trading volume play an important role in the dissemination of private information to the investing public. In particular, insiders' purchases (sales) are found to be a good indication of good (bad) news. The information content in insiders' trades may be exploited, provided investors are able to realize returns within one, and at most two months, after the announcement date.

Keywords: Insider trading; Efficient market hypothesis

1. Introduction

Since the publication of [11,12], a myriad of studies have emerged over the past decade regarding the usefulness of insider trading. Proponents of insider trading argue that insider trading leads to informa-

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tionally efficient stock prices while critics question the merits of these arguments, contending that insider trading leads to a loss of investor confidence in capital markets. In spite of this ongoing controversy, insider trading continues to interest investors, policy makers, regulators and the academic community. Investors are mainly concerned with insider trading in terms of how it may be beneficial; for policy makers and regulators, on the other hand, their interest is in maintaining a level playing field for all investors. Regardless of the motivation behind the various interest groups, insider trading is a practice that is not necessarily motivated by informational reasons only. Other possible reasons include manipulation, liquidity, and portfolio diversification. While knowledge about insider trades may enable one to gain informational advantage, decrease one's risk exposure, or enable one to adopt a more aggressive stance in the market, the risks involved and, particularly, the probability of success from imitating insiders is low.

Essentially, insider trading may be defined as "the dealing by an 'insider' in listed securities" when the 'insider' is in possession of price sensitive information that is generally not available to the public. While many believe that insider trading is illegal; this is, in fact, a misconception. The law only prohibits certain specific transactions by insiders; the majority of insider trades actually fall within legal boundaries. Secondly, reported legal insider trades are believed not to contain any important information and are, therefore, not seen as a useful investment guide. This is mainly because insiders tend to report only unprofitable transactions and are likely to camouflage transactions motivated by exploiting non-public information so as to avoid possible prosecution. Regulators of various securities exchanges acknowledge that the presence of insider trading regulations gives some assurance to potential investors that the market is fair and transparent. In fact, the regulation of insider trading is usually justified on the grounds of fairness or equity.

Yeo [17] points out that there are three main theoretical foundations that form the legal framework for the regulation of insider trading, namely misappropriation theory, unfair advantage theory and the market stability theory, which we examine in this paper. We also attempt to investigate the mechanism by which insider information becomes incorporated into stock price and whether insiders' trades act as buying or selling signals for the average investor. Specifically, our study aims to determine whether insiders' purchases indicate positive corporate earnings announcement news and insiders' sales indicate negative corporate earnings announcement news. We compare the strength of these trading signals and determine their role in the information dissemination process. These results are also observed at four different time points to determine if the information effects of the insiders' trades persist. The data that we use comprise information on 74 companies listed on the Singapore Exchange over the period January 1994–December 1998.

In Section 2, we discuss the insider trading provision in Singapore. Section 3 presents the data while Sections 4 and 5 discuss the information content hypothesis and the trading signals hypothesis, respectively. Following this, Section 6 explains the event study response to insider trades. The empirical results are analyzed in Sections 7 and 8. In Section 7, results of the portfolio formation and regression estimates are presented while Section 8 presents the sub-sample portfolio results. Section 9 concludes the paper.

2. Insider trading provision in Singapore

The present insider trading provisions in Singapore are found in Section 103 of the Securities Industry Act (SIA). Enacted in 1986, Section 103 was modelled after Section 128 of the Australian Securities