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Opportunistic insider trading[☆]

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ABSTRACT

This study proposes a simple framework to disentangle insiders' opportunistic trade from liquidity trade. An opportunistic trade occurs when the probability of informed trading and the speed of convergence to market efficiency increase in a month of an insider transaction. Using Thailand Securities Exchange Commission (SEC) insider filing reports during 2002 to 2008 we find an average insider achieves merely 0.64% and 0.32% in a month after an insider purchase and sell but an opportunistic portfolio yields approximately 2%.

1. Introduction

Prohibiting insider trading is a common practice in almost all stock exchanges around the world. At least 22 developed countries and 80% of the 81 emerging markets had insider trading laws in place in 1998 (Bhattacharya and Daouk, 2002). A widespread existence of insider trading regulation around the world reflects a unanimous view of regulators that insider trading should be prohibited to protect outsiders and assure a level playing field. While regulators believe insiders exploit their superior private information through trading, the evidence in the academic literature on profitability of insider trading is far from being conclusive.

Early evidence shows insider trading is informative because outsiders could achieve abnormal profit from observing insider trade information[1]. Aboody and Lev (2000) suggest the source of insiders' private information come from the ability to planned changes in the research and development budgets. In contrast, recent evidence is inconsistent with prior research. Lakonishok and Lee (2001) show limited market movement when insiders trade or report their trade to Securities Exchange Commission (SEC). Jeng et al. (2003) find insiders sales do not significantly earn abnormal returns. Eckbo and Smith (1998) show evidence in an insider friendly market such

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[1] See among others Lorie and Niederhoffer, 1968; Jaffe, 1974; Seyhun, 1986, 1988; Rozeff and Zaman, 1988; Lin and Howe, 1990.

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as the Oslo Stock Exchange (OSE), a conditional performance measures that closely tracks the true insider trades performance more than the traditional event study methodology reveal zero or negative abnormal insider returns. They conclude either OSE insiders possess little information or insider's benefits of control outweigh their benefits of trading.

Are insiders really informed? An informed insider conveys superior and useful information to outsiders via their trades. If this is the case, one should expect price efficiency to increase following trading of an informed insider. Nevertheless, not all insider trades equally contain relevant information. An insider trade could be uninformative and does not improve price efficiency if the objective of such trade is for liquidity. We therefore disentangle opportunistic trades from liquidity trades. Only opportunistic insiders exploit their superior information to trade and contribute to price efficiency.

Separating opportunistic insider from liquidity insider is highly relevant for the regulator to understand the impact of insider trade on the financial market. Only a few studies explicitly distinguish the role of opportunistic insider trade from liquidity insider trade. This study offers two contributions to the opportunistic insider trading literature. First we suggest a simple measure of opportunistic insider trade. The empirical measures of opportunistic insider are very useful for regulators to enforce the insider dealing legislation. We propose a measure of opportunistic insider trading that is consistent with a theoretical prediction of Leland (1992) who studied the consequence of insider trading under a rational expectation model with an endogeneous investment level. When insider trading is permitted, markets are less liquid as a result of asymmetric information and stock prices better reflect information. Aktas et al. (2008) show that price discovery happens sooner on insider trading days. Brunnermeier (2005) shows a trader who possesses a noisy signal of the forthcoming public announcement can use the information when he possesses it. The information leakage increases information asymmetry but makes the price more informative in the short-run. This suggests asymmetric information and informational price efficiency will jointly increase following a period that opportunistic insider trades.

Our second contribution is the study of profitability of opportunistic insider trades. After classifying insider trades based on opportunistic and liquidity based motivation, we revisit the profitability of insider trading evidence. In particular we test the idea that outsiders who follow opportunistic insider trades should on average benefit from their trades. We compare profitability of opportunistic and liquidity based insider trades. All empirical studies on profitability of insider trade so far do not explicitly differentiate opportunistic trading from liquidity trading. The investigation of insider trading performance conditional on the degree of opportunistic trading should allow us to shed more light on to why some studies do not find insiders trading informative. We look at the profitability to insiders and to outsiders who construct the strategy using insider filing report. We ensure that the strategy is implementable in real time by considering insider transaction records in the form 59-2 reports that are publicly available to investor by the end of month $t-1$ when the value weighted opportunistic insider portfolio is formed. Selected stocks will remain in the portfolio for 1 month. The portfolio return is then measured over the month t. Furthermore Meulbroek (1992) reports that a number of litigation cases against insider share sale are much higher than insider share purchase. Hence we examine whether an opportunistic insider sale would achieve higher profit than an opportunistic insider purchase.

The concept of "opportunistic insider trading" is close to the notion of "abnormal insider trading" which is used to isolate information-based component (e.g., Aktas et al., 2008; Jenter, 2005). Three recent researches suggest the methodology to identify opportunistic insider trades. Rozanov (2008) proposes the 'PricePattern' as a proxy for opportunistic trading. The 'PricePatterm' is computed from the ratio of the 20-trading day cumulative market-adjusted gross return after an insider trade to the 20-trading day before an insider trade. The high value of 'PricePattern' indicates increased likelihood of opportunistic insider trade. Gunny et al. (2008) propose the 'OIT' as a measure of opportunistic insider trading. The OIT captures a reverse pattern in abnormal returns around an opportunistic insider trade. In particular, one should observe a negative abnormal return prior to an opportunistic insider stock purchase and positive abnormal return subsequently. While 'PricePattern' and 'OIT' measures are very useful to study the relation of corporate governance and opportunistic insider trading, both measures cannot be computed ex-ante because 'PricePattern' and 'OIT' measures assume that opportunistic insiders profit from their firm-specific information. Moreover, while such assumption appears reasonable, a rising tide could lift all boats. Market-wide aggregate information such as economy and business conditions can be informative about future return (Albuquerque et al., 2008), and there is a possibility that market-wide information may offset the firm-specific private information. Furthermore Eckbo and Smith (1998) use a comprehensive database that tracks movement of insiders in and