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Does insider trading regulation deter private information trading? International evidence ☆

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Abstract

Using a sample of 2189 firms from 21 countries we find that, on average, stricter insider trading regulations reduce private information trading. However, for firms with high agency costs, insider trading restrictions are less effective in deterring private information trading. We suggest that controlling shareholders who are banned from trading may resort to covert expropriation of firm resources thereby reducing transparency and increasing the returns to private information trading. Consistent with this, we find that firms with higher agency costs located in countries with stricter insider trading laws have more opaque earnings and are valued lower.

JEL classification: G15; G14; G38
Keywords: Insider trading regulation; Ownership wedge; Private information trading, Earnings opacity

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1. Introduction

There is a long-standing debate in the finance, economics and law literatures about the need for insider trading regulation. Its critics argue that insider trading may serve as an efficient form of compensation for insiders. Moreover, insider trading allows private information to be quickly incorporated into stock prices, thereby leading to more informationally efficient stock prices (Carlton and Fischel, 1983; Dye, 1984). Proponents of insider trading regulation contend that insider trading subjects uninformed outsiders to an adverse selection problem, discourages investment, and damages corporate value (Manove, 1989; Ausubel, 1990; Fischer, 1992). Moreover, allowing insiders to trade at the expense of uninformed outsiders diminishes investor confidence and hurts the integrity of capital markets (Brudney, 1979; Easterbrook, 1985; Glosten, 1989; Maug, 1995, 2002).

In keeping with the latter viewpoint, many countries have adopted insider trading laws. A survey by Bhattacharya and Daouk (2002) finds that out of 103 countries that have stock markets, 87 have introduced insider trading rules. A principal goal of introducing insider trading restrictions appears to be to prevent informationally advantaged insiders from trading at the expense of the uninformed public. The objective of this paper is to examine whether insider trading regulation achieves its goal. Specifically, we examine whether insider trading regulation, on average, deters private information trading. Using a sample of 2189 firms from 21 countries we find that it does. A cross-sectional regression analysis shows that firms in countries with stricter insider trading restrictions are less subject to private information trading. Since the cross-sectional analysis is likely to suffer from endogeneity problems, we also conduct an event study which compares private information trading before and after the enforcement of insider trading restrictions. Consistent with the cross-sectional results, the event study reveals that the amount of private information trading decreases significantly after the first enforcement of insider trading laws.

This paper also examines whether the effect of insider trading restrictions on private information trading depends on the degree of agency problems inherent in the firm. We measure agency costs as the ownership wedge—the difference between control rights and cash flow rights of the largest shareholder. Greater separation of ownership and control is indicative of entrenched shareholders who often use firm resources to generate private benefits of control that are not shared by minority shareholders. In the presence of insider trading restrictions, entrenched controlling shareholders are more likely to have an incentive to continue trading as well as the means to mask the trades using various methods like offshore accounts, nominee accounts, etc. Therefore, we expect insider trading restrictions to be less effective in reducing private information trading in stocks of firms with a higher ownership wedge. Our data show that although insider trading restrictions lower private information trading on average, they are significantly less successful in doing so when the ownership wedge is high. This result supports the notion that controlling shareholders of firms with greater ownership wedge are less likely to be deterred from insider trading by the introduction of insider trading restrictions.

Another theme of our paper is to argue that the observed positive association between insider trading restrictions and private information trading in stocks with high ownership wedge may exist because insider trading restrictions foster greater information asymmetry in firms afflicted with high agency costs. We argue that restricting insider trading without closing other channels of expropriation may encourage controlling shareholders with high ownership wedge to seek other methods of diverting resources away from minority shareholders.[2] When controlling shareholders engaged in

[2] Other methods of expropriating resources from a firm may include elaborate transfer pricing schemes, special dividends, perquisites and outright stealing (Shleifer and Vishny, 1997; Johnson et al., 2000).