Insider trading legislation and corporate governance

Ernst Maug *

School of Business and Economics, Humboldt-Universität zu Berlin, Spandauer Strasse 1, D-10178 Berlin, Germany

Abstract

This paper analyzes the impact of insider trading legislation on corporate governance. In a context where large, dominant shareholders can monitor underperforming companies, managers have an incentive to give early warnings about adverse developments to dominant shareholders. This information is effectively a bribe to induce dominant shareholders to sell their stock and refrain from intervention. If insider trading is unregulated, dominant shareholders collude with management at the expense of small shareholders. The optimal regime forces the company to disclose all material information to the market. Private contracting between companies and shareholders leads to optimal insider trading regulation only if initial shareholders can enter a binding commitment, otherwise large shareholders and managers recontract at the expense of small shareholders. Enforcement also matters. European Union legislation requires inside information to be precise. Such a narrow definition creates a grey zone, where information is private but cannot be classified as inside information. As a result the effectiveness of corporate governance and firm value are reduced. Regulation in the US that treats shareholders with a stake exceeding 10% as insiders is potentially harmful.

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1. Introduction

It is felt (...) that institutional shareholders have a responsibility actively to encourage contact with companies which will include contact a senior executive level

* Tel.: +49-30-2093-5641; fax: +49-30-2093-5643.
E-mail address: maug@wiwi.hu-berlin.de (E. Maug).
URL: http://www.wiwi.hu-berlin/konzern
on both sides. (...) Institutions do not wish to be made insiders, and such contacts should not include the transmission of price-sensitive information.

Institutional Shareholder Committee, 1991

The objective of this paper is to analyze the welfare implications of insider trading regulation and disclosure requirements from a corporate governance perspective. This paper argues that insider trading legislation is an important factor for regulating the relationship between a company and its major shareholders. The focus is on the incentives of managers to disclose information to investors, and the incentives of dominant shareholders to monitor underperforming companies. Previous research on insider trading has focused either on incentive issues or on the link between informationally efficient stock markets and optimal investment decisions.\(^1\) The main hypothesis here is that insider trading prohibition implies that the interests of dominant shareholders are aligned with those of small shareholders, whereas dominant shareholders collude with management absent such a prohibition. Also, enforcement with civil penalties by supervisory agencies is superior to enforcement through the criminal law.

In an environment where insider trading is not regulated, dominant shareholders and managers collude and communicate information privately. Managers warn major shareholders early about negative developments, because then large shareholders are more likely to sell their stock at inflated market prices than to intervene in the company.\(^2\) Large shareholders benefit from these warnings since they can make trading profits. Hence, managers can “bribe” large shareholders with information to refrain from intervention in order to protect their rents. In this environment, the value of the firm is minimized. If insider trading is not regulated, then the incentives of the large shareholder are aligned with those of management, and both profit at the expense of small shareholders. This is the dark side of large shareholder activism (see Rock, 1994).

Profits from trading on inside information are an opportunity cost of monitoring, and prohibition of insider trading reduces or eliminates this opportunity cost. In the optimal environment the company has to disclose all material information to the market in a timely manner. Then outside monitors make optimal decisions, and the likelihood of monitoring and the value of the firm are maximized, whereas managers’ benefits from control are minimized. Hence, mandatory disclosure aligns the incentives of dominant shareholders with those of small shareholders at the expense of management. Therefore, insider trading regulation is critical for the coalitions that form between different constituencies of the firm.

The argument also makes a case for statutory prohibitions of insider trading. In principle, the choice of insider trading regulations could be left to private contracts between companies and their shareholders. Initial shareholders who take a company public prefer a strict insider trading standard, and if they can enter binding commitments, regulatory


\(^2\) Here and in the following the terms “monitoring” and “intervention” are used synonymously. Also, “monitoring” does not entail any active information gathering. The decision to receive information or not is treated separately later.
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