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# The impact of illegal insider trading in dealer and specialist markets: evidence from a natural experiment<sup>☆</sup>

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## Abstract

We examine insider trading in specialist and dealer markets, using the trades of stock brokers who had advance copies of a stock analysis column in *Business Week* magazine. We find that increases in price and volume occur after informed trades. During informed trading, market makers decrease depth. Depth falls more on the NYSE and Amex than on the Nasdaq. Spreads increase on the NYSE and Amex, but not on the Nasdaq. We find none of these pre-release changes in a nontraded control sample of stocks mentioned in the column. Our results show that insider trading has a negative impact on market liquidity; depth is an important tool

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to manage asymmetric information risk; and specialist markets are better at detecting informed trades.

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## 1. Introduction

Many market participants believe that insider trading poses a threat to the operation of financial markets. However, this proposition is difficult to test because few studies of insider trading have been conducted in which researchers can say they knew for sure that traders used material, nonpublic information. Most studies rely on the position of a trader (e.g., company official or board member) to infer access to, and use of, such information.

In this study, we examine data from a recent court case on insider trading that involved 116 publicly traded companies. Five stockbrokers acquired information on these firms from *Business Week's* "Inside Wall Street" (IWS) column, which they received the day before its public release. Although not based directly on company news, trades based on prior knowledge of the IWS column yielded abnormal returns. Because the brokers traded only a third of the 116 stocks, this episode offers a natural experiment on the impact of informed trading in financial markets. Also, because the stocks involved were listed on the NYSE, Amex, and Nasdaq, the data yield the first comparison of the effects of illegal insider trading in dealer and specialist markets.

For all stocks traded by the stockbrokers and for most other IWS stocks, we have data on transactions and quotes for three days around the insider trading day. Court records from the civil and criminal cases identify the brokers' trades within the transaction stream. By aggregating the trade and quote data in 15-minute intervals, we obtain a detailed picture of market behavior during and immediately following periods of insider trading activity.

We find strong evidence that illegal insider trading has a negative impact on market liquidity. Our analysis shows that market makers adjust both depth and spreads to manage the risk presented by informed traders.<sup>1</sup> Depth falls in both specialist and dealer markets, but spreads increase only in specialist markets. All these informed trades involve purchases, and we find that only ask depth changes significantly. Relative to the average quoted depth on the previous day, ask depth is 38% lower for NYSE and Amex stocks during insider intervals. After controlling for lower Nasdaq depth, ask depth for Nasdaq stocks falls by only 3% during insider

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<sup>1</sup>Throughout the paper, we use the term market makers to refer to all liquidity providers, including specialists, dealers, and limit-order traders.

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