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Global Finance Journal 17 (2007) 439 – 453
Global Finance Journal

Informed trading and the consistent enforcement hypothesis: Evidence from bid–ask spreads in France and Britain

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Received 1 March 2006; received in revised form 1 May 2006; accepted 1 June 2006
Available online 21 November 2006

Abstract

This study addresses the issue of continuous legal enforcement on informed trading. Informed trading widens bid–ask spreads. Past studies show that one time enforcement of insider trading laws decreases bid–ask spread, but does not address repeat or continuous enforcement. Specifically, this study examines the introduction of insider trading laws on the bid–ask spreads in France and Britain. France has a much stronger record of enforcement than Britain does. According to the consistent enforcement hypothesis, French spreads should narrow more than British spreads because laws are made more credible by more enforcement. In France, the bid–ask spread narrows after the introduction of the new insider trading law even after controlling for other factors. The narrowing is related to the size of the spread before the introduction of the law. In Britain, the bid–ask spread does not narrow after the new insider trading law.

JEL classification: G14; G18; G19
Keywords: Insider trading; Bid–ask spread; Trading law; Effectiveness of law

1. Introduction

Adverse selection models such as those by Glosten and Milgrom (1985) and Kyle (1985) predict that information asymmetry widens bid–ask spreads. In equilibrium, the gains made on trades with non-informed traders should compensate market makers for losses incurred by trading with informed traders. A reduction of information asymmetry should reduce the adverse selection

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1044-0283/$ - see front matter
doi:10.1016/j.gfj.2006.06.011

component of the spread, and therefore, bid–ask spreads. The studies of Stoll and Whaley (1990), Chung and Charoenwong (1998) among others show empirically that insider trading and bid–ask spreads are related. Stoll and Whaley (1990) show that when stocks first open on the NYSE, volatility is caused partially by private information trading. Chung and Charoenwong (1998) show that bid–ask spreads are positively related to insider trading and stock volatility and negatively related to volume, price and firm size. Wang and Hsu (2006) describe insider trading as a market imperfection. Reducing it would improve market conditions and allow market makers to narrow spreads. Bhattacharya and Daouk (2002) relate bid–ask spreads and enforcement by showing that having insider trading laws alone is not enough to reduce bid–ask spreads. Enforcement is critical since it discourages insider trading. In their paper, enforcement is a dummy variable that takes on the value of unity at the first prosecution of insider trading. Their paper does not compare spreads based on how frequently they prosecute insider trading. While one prosecution is important, a strong tendency to prosecute should be more relevant for market makers than occasional enforcement of insider trading laws. This concept is summarized as the consistent enforcement hypothesis. The purpose of this paper is to test this hypothesis by showing that improving insider trading laws only change market behavior when enforcement of existing laws is strong and continuous. Specifically, this paper uses the examples of France and England, which have very different enforcement histories, to test the market reaction to new insider trading laws. Comparing the change in spreads across countries will shed light on the importance of continuous enforcement of laws to change behavior.

Trades involving information asymmetry are difficult to track since trading on insider information is illegal. In the United States company officers must report their identity when trading, but not all of their trades contain inside information. Furthermore, many informed trades are not reported since they are done by a non-officer of the company. Maug (1999) describes some of the difficulties caused by large stakeholders who collude with managers using inside information. One way of overcoming the difficulty of finding informed trades is to find an event that should universally reduce informed trading on all securities in a market. One such event is the introduction, or strengthening of insider trading laws. When a new law is introduced to limit insider trading, some holders of information will decide not to trade for fear of being punished for breaking the law, or out of desire not to break the law. Unlike the US that has had many insider trading laws for almost 75 years, many countries have only recently made insider trading illegal. During the 1980s and 1990s Europe instituted many laws making insider trading illegal. For example, the following countries made insider trading illegal in the last 30 years: France 1967, England 1980, Switzerland 1989, Japan 1989, Italy 1991 and Germany 1994. During the same period, insider trading laws modified and expanded the restriction on insider trading. Bid–ask prices were not available when most of these events occurred. The tracking of bid–ask prices in Germany started 2 years after the introduction of the law and data on Switzerland starts only 2 weeks before the event. France and Britain both passed laws at a time when bid and ask prices were collected on a daily basis for many stocks. For this reason, France and Britain are the focus of this study. As new insider trading laws are passed, further study will be possible.

On March 1, 1990 France amended the articles of la Commission des Operations de Bourse (COB), the French counterpart to the SEC. This law increases the COB's power in two ways. First, the new law allows the COB to prosecute any individual who trades using inside information. Prior to the law's introduction, prosecution of insider trading was limited to prosecuting the individual who passed on insider information, not the person who traded with it. The intent of the law is to restrict insider trading by holding more people accountable for their actions. Second, it allows the COB to prosecute cases in civil court as well as criminal court. The law allows the