Economic Systems 28 (2004) 209–228

ECONOMIC SYSTEMS

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Reexamination of the link between insider trading and price efficiency

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Abstract

This paper investigates insider trading patterns around quarterly earnings announcements of the companies listed on the Warsaw Stock Exchange. The results are generally consistent with the notion that insiders exploit their foreknowledge of accounting disclosures but cease trading aggressively immediately before the publication date. Their informed trading is shifted to an earlier period in order to make it less explicit and minimize the danger of possible legal action. Furthermore, insider dealing has been shown to have a negligible net effect on stock price efficiency, as the benefits of information transmission are likely to be counterbalanced by the reduction in information acquisition by outsiders. In particular, it has been shown that the market professionals are reluctant to follow companies in which insiders trade actively.
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JEL classification: C23; G14; G18; K22

Keywords: Insider trading; Price efficiency; Earnings announcements; Analyst following

1. Introduction

It is often contended that insider dealing is unfair and the failure to penalize violators of securities regulations can seriously undermine public confidence in capital markets.[1] Furthermore, the right to privileged information would be typically assigned to the company,

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[1] Individuals who are members of executive and supervisory bodies of the issuer, next of kin of these individuals and large shareholders are defined in Poland as insiders by Ministry Decree 2001 Dz.U. Nr 139, poz. 1569 and The Law on the Public Trading of Securities of 1997, § 147. The issuer is obliged to file a report with the Securities and Exchange Commission within 24 h following an insider transaction. The exploitation of preferential information is banned (The Law on the Public Trading of Securities of 1997, § 176).

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doi:10.1016/j.ecosys.2004.06.003

hence insider trading can also be viewed as theft of corporate property.[2] On the other hand, some deregulatory arguments voiced by academics emerge as equally persuasive. The exploitation of nonpublic information could be, for instance, an efficient way to compensate managers for their innovations (Manne, 1966; Carlton and Fischel, 1983; Roulstone, in press). Another channel through which insider trading could potentially benefit society is by promoting more accurate pricing of assets (Udpa, 1996; Roulstone, 2003).

This study endeavors to assess the genuineness of the last assertion, namely that the trading by insiders enhances market efficiency. If more inside information is contemporaneously discounted in securities prices, future price fluctuations will be dampened and risk-averse agents will be disposed to increase their investments (Leland, 1992). The results presented here suggest that this beneficial effect of deregulation is likely to be negligible. Although insiders on the Polish stock market seem to exploit, albeit in a subtle manner, their foreknowledge of the trends in the future financial performance of their companies, the return activity around earnings disclosures is not diminished by instances of prior insider trading. This could be due to the fact that insider trading reduces the economic incentives of market professionals to collect and analyze information, as in Fishman and Hagerty (1992) and Khanna et al. (1994).

The remainder of the paper is organized as follows. The following section offers a review of literature and develops three testable hypotheses. Section 3 provides data sources, variable definitions, and summary statistics. Empirical results are given and elaborated upon in Section 4. Section 5 concludes the paper.

2. Prior literature and hypotheses

This section enumerates the hypotheses to be tested and discusses the contributions in light of the extant literature. If managers and directors possess and trade upon private information regarding a firm's financial prospects, it is likely that this information will be impounded into stock prices before it is publicly released. Thus, ideally one would wish to test the following hypothesis first.

Hypothesis 1. Insiders exploit information about forthcoming earnings announcements in their security trading.

Several studies have pursued an investigation of the relationship between insider trading and subsequent earnings announcements, yet the overall evidence remains mixed. Elliot et al. (1984) and Lustgarten and Mande (1995) find that insiders purchase more shares prior to positive earnings surprises, but refrain from selling ahead of bad news. Givoly and Palmon (1985) investigate dealing activity around corporate news (predominantly financial statement disclosures), however fail to document any significant association. They assert that the abnormal returns following insider transactions are likely to be a manifestation of a self-fulfilling prophecy. Similarly, the results of Seyhun (1992, 2000) suggest that individuals subject to trading disclosure requirements do not exploit earnings information

[2] For a further discussion and a comprehensive survey of literature see Brainbridge (2000).

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