The impact of insider trading laws on dividend payout policy

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A B S T R A C T

We posit that firms use dividend payout policy to reduce information asymmetry and agency costs caused by country-level institutional weaknesses. Firms operating in countries with weak insider trading laws attempt to mitigate this institutional weakness by committing themselves to paying out large and stable cash dividends. We test this central hypothesis (among others) using an international sample of firms across 24 countries, as well as by conducting a case study during an enforcement action. The results show that weak insider trading laws lead to a higher propensity of paying dividends, larger dividend amounts and greater dividend smoothing. We also show that the market's valuation of dividend payouts is significantly higher when insider trading protection is weak. It is important to note that these insider trading results are not due to cross-country variations in investor or creditor protection, nor are they contingent on the enforcement of insider trading laws. Overall, our evidence supports the view that dividend payouts serve as a substitute bonding mechanism when country-level legal protections fail.

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1. Introduction

Over the past few decades, most national legislatures have enacted insider trading laws to protect outside shareholders from corporate insiders who have access to material, non-public information (Bhattacharya and Daouk, 2002). Although most countries now have legislation that restricts insider trading to some degree, there is considerable cross-country variation in the effectiveness of this legislation (Beny, 2008). And many countries that possess such legislation have never bought an enforcement action by investigating, prosecuting, and penalizing violators. Weak restrictions and the failure to enforce insider trading laws reduces a country's ability to minimize information and agency costs at the national market level. When country-level institutions fail to enforce implicit or explicit contracts, market participants create and rely on private enforcement mechanisms. Corporate executives, for example, can mitigate the impact of such institutional failures by employing firm-level bonding mechanisms. In this paper, we examine the degree to which corporate payout policy is used to reduce the adverse effects of country-level weaknesses in the restrictiveness and enforcement of insider trading laws. We hypothesize that firms will commit to large, stable dividend payouts to establish a reputation for the fair treatment of outside shareholders when the national government fails to prevent insider trading. Since this bonding mechanism is costly, we expect that firms will reduce their commitment to large, stable payouts once the national government demonstrates its willingness to enforce insider trading laws. Our empirical results support both hypotheses.

Our main research question whether firms actively set payout policies to counteract institutional weakness in their regulatory environments. That is, does firm-level payout policy serve as a substitute (i.e., bonding) mechanism for country-level institutional weakness? While previous research shows that the country-level legal and regulatory environment constrains individual firm behavior

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Table 1
International sample.
Summary statistics.
This table shows the summary statistics for the international sample that uses the insider trading laws restrictiveness index, *ITL*. *ITL* ranges between 1 (least restrictive) and 5 (most restrictive). The index components are based on Gaillard (1992) and Stamp and Welsh (1996). The restrictiveness index is defined for the period 1994–1997 from Beny (2008). Panel A shows the descriptive statistics. Panel B shows the number of observation by year. Panel C shows the number of observations by industry. Panel D shows the country level institutional variables. The anti-director rights index (*AD*) and creditor rights (*CR*) are from Djankov et al. (2007) and Djankov et al. (2008). Panel E shows the observations by country. *PAYER* equals one if the firm pays dividend (DVC > 0), otherwise equals 0. *DIV_TO_S* is the ratio of dividends (DVC) to sales (SALE). *RTE* is retained earnings (RE) scaled by the book value of assets (TA). *TE* is the shareholders' equity (CEQ) scaled by the book value of assets (AT). *ROA* is net income (NI) scaled by the book value of assets (TA). SGR_t is the logarithmic sales growth computed as log $(SALE_t/SALE_{t-1})$. $LOGSIZE_t$ is the natural logarithm of the book value assets (TA) in billion $US. $CASH_t$ is the cash and short-term investments balance (CHE) scaled by the book value of assets (TA).

Panel A: Descriptive statistics

Variable	N	Mean	Median	Std Dev	5th	25th	75th
PAYER	32,503	0.373	0.000	0.484	0.000	0.000	1.000
DIV_TO_S	32,503	0.009	0.000	0.026	0.000	0.000	0.008
DIV_TO_E	31,082	0.153	0.000	0.408	0.000	0.000	0.204
DIV_TO_CF	30,093	0.086	0.000	0.184	0.000	0.000	0.110
RTE	32,503	−0.397	0.083	1.839	−2.939	−0.214	0.259
TE	32,503	0.436	0.475	0.383	−0.085	0.303	0.665
ROA	32,503	−0.043	0.031	0.828	−0.601	−0.034	0.075
SGR	32,503	0.354	0.116	1.167	−0.297	−0.016	0.323
LOGSIZE	32,503	−2.320	−2.371	2.075	−5.657	−3.744	−0.946
CASH	32,503	0.160	0.081	0.197	0.001	0.021	0.221

Panel B: Number of observations by year

Year	ITL				
	1	2	3	4	5
1994	9	148	616	140	6034
1995	12	173	665	210	6360
1996	14	757	722	223	7051
1997	31	969	955	249	7165
Total	66	2047	2958	822	26,610

Panel C: Industry distribution

NAICS Industry definition	2-Digit NAICS code	N
Agriculture, forestry, fishing and hunting	11	137
Mining	21	1954
Construction	23	995
Manufacturing	31–33	15,838
Wholesale trade	42	1623
Retail trade	44–45	2362
Transportation and warehousing	48–49	857
Information	51	3657
Real estate and rental and leasing	53	551
Professional, scientific, and technical services	54	1375
Administrative and support and waste management	56	962
Educational services	61	111
Health care and social assistance	62	631
Arts, entertainment, and recreation	71	421
Accommodation and food services	72	834
Other services (except Public administration)	81	195
Total		32,503

Panel D: Country level institutional variables

Country	AD	CR	ITL
AUS	4	3	4
AUT	2.5	3	2
BEL	2	2	3
CAN	4	1	5
CHE	3	1	3
DEU	2.5	3	3
DNK	4	3	3
ESP	5	2	4
FIN	3.5	1	3
FRA	3	0	4
GBR	5	4	3
HKG	5	4	3
IRL	4	1	4
ISR	4	4	3