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Profitability of insider trading in Europe: A performance evaluation approach☆

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ABSTRACT

We use the largest cross-country sample of reported share transactions by corporate insiders to date to establish that insiders in the majority of European countries do not make statistically significant abnormal trading profits. This finding stands in contrast to the earlier evidence from the U.S. The result holds across subsamples of firms with different characteristics. Furthermore, the introduction of the European Union Market Abuse Directive (MAD) had a mixed impact on the frequency and volume of insider trading across countries but generally did not affect profits of insider-mimicking portfolios. We build on the heterogeneity of our sample countries to show that several country-level regulatory, economic and cultural factors are linked with the level of insider profits which can explain why the profitability of insider trading differs starkly across countries.

1. Introduction

There is major controversy around profits corporate insiders can make from trading in their firms' shares. By the nature of their jobs, insiders have privileged access to non-public information and, if they use that information in trading, they are likely to benefit at the expense of uninformed outside investors. While some argue that profits from insider trading are a form of compensation for managers (Manne, 1966; Carlton and Fischel, 1983) and that insider trading can bring potential welfare benefits for the whole society from more informationally efficient stock pricing (Manne, 1966; Leland, 1992), others point to flawed incentives insider trading creates and to a negative impact of insider profits on outside investors (e.g., Ausubel, 1990; Leland, 1992; Fried, 1998; Bebchuk and Fried, 2003). Regulators around the world focus on the harmful adverse selection effects of insider trading and take a clear stance by prohibiting trading on the basis of material nonpublic information, aiming to curb trading profits insiders can obtain. In this paper we use a data set of reported share transactions by corporate insiders in 18 European countries covering up to 14 years, the largest cross-country sample to date, to provide the first thorough exploratory analysis of the performance of insider-mimicking portfolios in Europe. We find that insiders in many countries across Europe, and particularly continental Europe, do not earn abnormal profits from their trades.

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This paper closely follows the setup in Jeng et al. (2003) who study profitability of corporate insider trading in the US They find that a portfolio mimicking insider purchase transactions outperforms the CAPM model by 68 basis points and the four-factor model by 52 basis points per month (more than 8 and 6 per cent per year, respectively), while the sale portfolio does not earn significant abnormal returns. Data on insider transactions across Europe became available only recently, with many countries introducing mandatory reporting of trades by corporate insiders throughout the 2000s. Our aim, hence, is to apply the methodology in Jeng et al. (2003) to new European data to provide a unified picture of insider trading profitability across Europe, compare it with the US evidence in Jeng et al. (2003) and shed more light on the question of whether country-level factors determine the profitability of insider trades.[1]

Following the approach in Jeng et al. (2003), we analyze purchase portfolios that consist of all shares bought by insiders in a given country and held over a specific period of time, and sale portfolios that consist of all shares sold. We then estimate whether such mimicking portfolios outperform the respective market on the risk-adjusted basis. As noted by Jeng et al. (2003), it is impossible to determine actual insider trading profits because information on stock holding periods is incomplete. For example, there is no information on an individual's trades before she becomes an insider (i.e., takes a position in the firm which requires reporting of trades under insider trading rules) or after she ceases being an insider. Hence, it is impossible to determine when all individual stock positions are opened or closed. Additionally, information on shares acquired in an equity-based compensation scheme over the individual's career can be imperfect or incomplete. Because of these data limitations, one has to rely on a proxy for insider returns based on an assumption about the holding period; hence, this approach measures *realizable* and not *actual* returns. Jeng et al. (2003) assume a six-month holding period consistent with the short swing trading rule in the US that effectively bans round-trip share transactions by corporate insiders in a period shorter than six months. Because to the best of our knowledge there is no equivalent of the short-swing trading rule in Europe, we choose different holding periods and look at horizons of 1, 3, 6 and 12 months.

Our results can be summarized as follows. We find that insider portfolios generate significant risk-adjusted abnormal returns, α's, in only few European countries. For both purchases and sales we find evidence of the average profitability decreasing with the holding horizon, indicating the short-lived nature of insider information advantage. The results are similar across sub-samples of firms with specific characteristics related to transparency (size, analyst coverage and industry classification and ownership structure), indicating that there is no group of firms in which insider trading is consistently profitable. We also find that the introduction of the European Union Market Abuse Directive (MAD) into local laws changed insiders' trading patterns, with a mixed picture across countries: insiders post-MAD trade more frequently but in lower quantities or trade with the same frequency but in larger quantities per trade, but overall the introduction of the MAD had no systematic significant effect on returns generated by insider portfolios.

Differences in insider trading profitability between our sample countries and also the stark contrast between the, on average, low profitability in Europe compared to the US indicate that structural differences between countries can affect insider profits. In an attempt to shed light on those differences we run further cross-sectional tests in which we regress α's to insider portfolios in individual countries on a number of regulatory, economic and cultural country-level factors. We find some evidence that insider trading profits are linked with the overall investor protection, trading costs, religiosity, trade reporting deadlines and the strictness and enforcement of insider trading rules in the country. Specifically, we find that insider buying is more profitable in countries with stronger investor protection, in less religious countries and when trade reporting deadlines are longer, and the profitability is also positively linked with trading costs. For sale transactions, our results indicate that insider trading is less profitable in countries with more stringent and better enforced MAD rules. Overall, our findings of the importance of country-level factors for insider profits potentially explain why the profitability of insider trading is likely to differ significantly across countries.

This study complements papers that analyze abnormal stock returns following insider transactions using the event-study methodology in individual countries (e.g. Friederich et al., 2002; Fidrmuc et al., 2006; Betzer and Theissen, 2009; Ravina and Sapienza, 2010; Gregory et al., 2013) or in multi-country samples (Aussenegg and Ranzi, 2008; Dardas and Guettler, 2011; Fidrmuc et al., 2013). As noted by Jeng et al. (2003), the event study methodology is best-suited to answer a question of how informative insider trades are for future returns but it fails to address a complementary question of returns earned by corporate insiders from trading. Towards that end, the approach applied in this paper to analyze portfolios mimicking all insider transactions in a country over time has several advantages. It implicitly accounts for the transaction volume and, hence, is closer in reflecting the actual insider portfolio as opposed to equal weighting of transactions in event studies. It is also focused on observing a time series of insider portfolio composition and performance, including a sequence of trades within a company and across companies, as opposed to the cross-sectional approach in event studies. Therefore, the performance evaluation approach employed in this study helps to deal with the problem of cross-sectional dependence across trades that hampers statistical inferences about the average abnormal performance in event studies.

The remainder of this paper is organized as follows. Section 2 compares key characteristics of regulations of insider trading and reporting of insider trades in Europe. Section 3 presents data on insider transactions used in this paper and Section 4 introduces the methodology. Section 5 presents and discusses empirical results on the profitability of insider trading in Europe, including a battery of robustness checks, tests in subsamples and the impact of the MAD on insider profits. Section 6 explores cross-country determinants of the profitability of insider trading, and Section 7 concludes the paper.

[1] In a related study, Eckbo and Smith (1998) apply an alternative time-varying expected return framework to analyze insider portfolios in Norway and fail to find any abnormal performance.