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Stock Splits to Profit Insider Trading: Lessons from an Emerging Market

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Abstract

Stock splits have long presented financial puzzles: Why are they undertaken? Why are they associated with abnormal returns? Abnormal returns, particularly those coming shortly before a split's announcement date, should raise strong suspicions of insider trading, particularly in nations with weak regulatory structures. We examined the 718 split events in the emerging stock market of Vietnam from 2007 through 2011. We found evidence consistent with illegal insider trading, particularly in firms that were vulnerable to insider manipulation and, therefore, more likely to split their stocks. When vulnerable firms' stocks did split, they provided significant excess short-term returns. Tellingly, the abnormal returns on those stocks prior to the split announcements were also extremely high, indeed higher than their abnormal post-announcement returns. Moreover, trading volume increased prior to the split announcement date. This suspicious pattern is what we would expect if insiders were trading on their knowledge. We propose that illegal insider trading in contexts where it is possible to escape serious penalty provides a previously undiscussed and cogent explanation for both stock splits and abnormal short-term returns.

Keywords: insider trading, stock split, state ownership, emerging market, corporate governance.

JEL Classifications: G1, G2, G3

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