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Corporate insider trading in Europe

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ABSTRACT

We analyse stock price behaviour around the disclosure of corporate insider transactions after the introduction of the Market Abuse Directive (MAD). Ranking according to our Insider Trading Enforcement (ITE) index highlights significant differences in the MAD enforcement between French and German legal origin countries. We document contrarian behaviour of insiders in all of the sample countries. Insiders reveal significant information to the public through both their purchases and sales. The price impact of the insiders' transactions is particularly strong in countries with a lower ITE index (i.e. weaker public enforcement).

1. Introduction

While insider trading regulation has existed in the US since 1934 and in the UK since 1976, comparable regulatory requirements were only developed in continental Europe in the last twenty years. The European Community (EC), in its efforts to strengthen the integrity of the member states' financial markets and thereby enhance market efficiency, released the Insider Dealing and Money Laundering Directive (89/592/EEC) in 1989. The directive legally defined insiders and insider information and was transposed into national law during the 1990s by most of the member states. In 2003, the Market Abuse Directive (MAD) (2003/6/EC) replaced the old (1989) directive.[1] The overall objective was to introduce a European Union (EU) standard for insider dealing and market manipulation so as to promote market integrity and instill investor confidence in the financial markets.[2]

The importance of the enforcement of securities laws and regulations against financial markets misconduct has been documented in prior international studies (see Cumming et al. (2015) for an excellent synthesis of relevant studies). The

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[1] The directive 2003/6/EC is complemented by four other EU initiatives, namely the Commission Directives 2003/124/EC, 2003/125/EC and 2004/72/EC and the Commission Regulation 2273/2003. The non EU-member Switzerland implemented a similar regulation that closely follows the definitions of the EU regulation (see ESMA, 2012).

[2] A comprehensive analysis of the Market Abuse Directive is provided in Siems (2008).

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evidence about the relative importance of private and public enforcement of securities laws for financial market development is, however, inconclusive (e.g., Djankov et al., 2008; Jackson and Roe, 2009). Since recent regulation was not introduced in response to a specific case of market abuse in any of the EU countries, but was mandated (exogenously) by the EU, it represents a unique natural experiment (Aitken et al., 2015). This experiment, therefore, allows us to examine the importance of public enforcement of the MAD on insider dealing across European countries. Specifically, we analyse the information content of insider trading disclosures in seven continental European countries: Austria, Belgium, France, Germany, Italy, the Netherlands, and Switzerland. Our sample comprises 46,172 insider trading disclosures from 2096 companies during the period 1st January 2006 to 31st December 2013. Thus, our sample period begins after the implementation of the MAD and, therefore, includes countries with the same regulation. Notably, all sample countries are governed by civil law with less emphasis on private litigation compared to common law countries (see Jackson and Roe, 2009). The sample countries are, however, split between German (Austria, Germany, and Switzerland) and French (France, Belgium, Italy, and Netherlands) legal origin with important differences.[3] Previous literature, for example, document differences between German and French legal origin countries in: (i) the development of financial intermediaries and markets (Beck et al., 2003); (ii) strategies for protecting minority shareholders and creditors (La Porta et al., 1998); (iii) regulation of security issuance through security laws (La Porta et al., 2006); (iv) and regulation of insider trading (Cumming et al., 2011). It is, however, not clear whether German or French legal systems generate better public enforcement in the area of insider dealing.

The differences in public enforcement of the MAD among our sample countries could lead to varying price effects following the disclosure of insider transactions. For example, weaker enforcement leads to investors' mistrust and less transparent markets. This in turn results in less reliable information available to investors. Accordingly, we predict more positive abnormal returns after purchases and more negative abnormal returns after sales in countries with weaker public enforcement of insider regulation.

Jackson and Roe (2009) and Fidrmuc et al. (2013) are works closest to ours, although our approach differs from prior work in two important ways. First, we develop an index for our sample countries that focuses specifically on public enforcement of the MAD in the context of insider trading. Our public enforcement Insider Trading Index (ITE) combines regulators' formal legal powers (sanctioning approach, penalties, and disclosure of decisions), resource-based measures of public enforcement (supervisory capacity), and evidence on actual enforcement activities (number of sanctions and discharges). The importance of information on the actual enforcement activities was highlighted in previous literature (e.g., Bhattacharya and Daouk, 2002; Jackson and Roe, 2009) but has not been examined due to lack of data. Bhattacharya and Daouk (2002), for example, suggest that for efficiency of insider trading regulation the key issue is not whether formal powers exist, but whether regulators actually exercise the powers by sanctioning offenders.

Second, Fidrmuc et al. (2013) use the anti-self-dealing (ASD) index of Djankov et al. (2008) as a measure of legal protection of minority shareholders against expropriation by corporate insiders.[4] Although relevant to insider dealing, self-dealing (or "private benefits of control") does not specifically include insider dealing.[5] Furthermore, the ASD index is a proxy for private rather than public enforcement and has been calculated based on legal rules prevailing in 2003, thus, long before the implementation of the MAD.

Our main findings are first that French legal origin countries (France, Italy, Belgium, and Netherlands) score significantly better in terms of the ITE index compared to their German (Austria, German, and Switzerland) origin counterparts. The results are robust compared to alternative proxies for ITE constituents. Second, insider purchase transactions tend to take place after decline in abnormal returns. The purchases create a significant positive price effect resulting in positive cumulative abnormal returns (CARs). This positive effect is more pronounced in countries with a lower ITE Index (weaker public enforcement). The effect of prior sales and firm size are negative and statistically significant in all sub-periods, whilst transaction volume is significant during and after the financial crisis only. Overall, we find evidence for the existence of typical contrarian strategies for insider purchases. Third, we report relevant pricing information for sale transactions, in contrast to corresponding findings for the US (Lakonishok and Lee, 2001). Insiders also tend to adopt contrarian strategies when they sell shares of their own companies. The enforcement of insider trading regulation plays an important role for sale transactions only during the crisis period, a period characterized by a much larger information asymmetry between insiders and outside investors.

The paper is structured as follows. We begin in Section 2 by a review of the relevant literature and motivation of our research hypotheses. In Section 3 we explore the enforcement of regulation on insider trading and develop our ITE public enforcement index. In Section 4 we describe our dataset and the sample selection procedure, and in Section 5 we present the chosen methodology. The empirical results are discussed in Section 6, followed by robustness checks in Section 7. Concluding remarks are set forth in Section 8.

[3] We follow the La Porta et al. (1998) classification of legal origin.

[4] Shleifer and Vishny (1997) list the following forms of self-dealing: executive perquisites, excessive compensation, transfer pricing, appropriation of corporate opportunities, self-serving financial transactions such as directed equity issuance or personal loans to insiders, and outright theft of corporate assets.

[5] The ASD index focuses on the following question: "if a controlling shareholder wants to enrich himself while following the law, how difficult is it for minority shareholders to thwart such activity before it takes place and to recover damages if it does occur?" (Djankov et al., 2008, page 432).

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