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Bidder country characteristics and informed trading in U.S. targets

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ABSTRACT

Information leakages experienced by U.S. targets in the pre-bid period are especially pronounced when they involve foreign bidders whose countries have weak insider trading sanctions, are perceived to have prevalent insider trading activity, have a low level of local merger activity, and are not classified as common law countries. Among foreign countries, information leakages are less pronounced when the bidder's government has a cooperative agreement with the SEC. Enforcement cooperation agreements signed between the SEC and foreign regulators serve as an effective means of enforcing the stricter U.S. insider trading laws on a more global scale.

1. Introduction

When informed traders act on illegal inside information prior to merger announcements, they can earn large trading profits (Schwert, 1996). However, their ability to earn large trading profits might discourage other traders who are at a disadvantage from participating in stock markets (Leland, 1992). In addition, as information leakages cause a stock price run-up prior to a final merger agreement, they can force bidders to pay higher prices for targets to take control of ownership (Schwert, 1996), and therefore might disrupt the market for corporate control.

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The existence of information leakage about U.S. targets prior to announced mergers has been documented in the form of a large abnormal stock price run-up by Keown and Pinkerton (1981), Keown et al. (1985), Cornell and Sirri (1992), Meulbroek (1992), Schwert (1996), Chakravarty and McConnell (1997), Meulbroek and Hart (1997), and Chira and Madura (2013). The degree of the information leakage can vary with the type of merger and other conditions, which mean that the potential damage of insider trading to other investors or to bidders in the market for corporate control may vary with these conditions.

Our interest is in the special case of merger bids involving U.S. targets that are pursued by foreign bidders based in developed countries. Brigida and Madura (2012) find that information leakages of U.S. targets are more pronounced when acquired by foreign bidders than by U.S. bidders. However, their study is focused mostly on identifying domestic characteristics that can cause informed trading, and they do not closely examine cross-border mergers. The pronounced information leakages resulting from merger bids by foreign bidders may be attributed to a lack of regulation or enforcement of illegal insider trading outside the U.S. (Du and Wei, 2004). While insider trading laws converge on the scope of prohibition across countries, they tend to diverge in terms of civil and criminal sanctions levied on illegal inside traders. Some jurisdictions impose pre-defined fines for illegal insider offenses, while others disgorge profits earned (or losses avoided) in addition to punishing offenders with fines. Also, illegal insider trading has only recently been upgraded from a civil violation to a criminal offense in some countries.[1] The maximum prison term sought for those convicted of insider trading violations tends to be much lower than in the U.S.

Enforceability of insider trading laws is further hampered by the way those laws are defined. Maug (2002) suggests that the definition of inside information is very specific in some European countries, which makes it difficult to prove that an illegal act occurred. While most Asian countries have enacted insider trading legislation, a recent article in the Financial Times suggests that prosecutions of insider dealing are "either rare or non-existent" since "in Asia,. . ., nobody cares."[2] Although Japan has had insider trading laws in place since 1988, a recent article in *complianceweek.com* states that "even today many Japanese do not understand why this is illegal. Indeed, previously it was regarded as common sense to make a profit from your knowledge."[3]

To the extent that informed traders outside the U.S. are willing to engage in illegal insider trading on their local stocks, they may perceive that they can engage in illegal insider trading on U.S. stocks with impunity in their own countries. DeMarzo et al. (1998) state that enforcement of insider trading regulation is costly, and thus regulatory authorities might only prosecute an illegal insider trading case when the benefit of doing so (i.e., the sum of disgorged profits and penalties obtained) exceeds the cost of investigating the case (i.e., the amount spent on discovery process).

While the trading of U.S. stocks on U.S. exchanges is subject to U.S. regulation, the U.S. enforcement of insider trading by foreign traders requires cooperation with foreign governments. U.S. regulators face constraints in retrieving necessary information from foreign authorities to prosecute cases involving foreign traders, which may discourage regulatory enforcement of foreign insider trading of U.S. stocks. If foreign traders are less likely to be penalized for engaging in illegal insider trading of U.S. target stocks, they should be more likely to pursue it.

Given the cross-country variation in insider trading laws and enforcement, the degree of information leakage of U.S. targets pursued by foreign bidders may vary with the enforcement of the bidder country's insider trading laws. We investigate whether information leakages are more pronounced for U.S. targets whose bidders come from countries with less effective insider trading regulations. We

[1] In most European nations, illegal insider trading was not considered a criminal offense: "In the case of insider dealing, the maximum fines imposed by some countries, like Spain, Poland and Sweden are capped below 1 million euros, while only 12 countries impose sanctions corresponding to the amount earned from the violation, according to European officials." Only recently must this perception have been revised since the European Commission empowered by the stipulations of the 2009 Treaty of Lisbon has recommended to E.U. member nations that they criminalize illegal insider trading. The information has been obtained from the following website: http://www.nytimes.com/2010/12/09/business/global/09criminal.html?_r=4&ref=business.

[2] The information comes from the following website: http://www.ft.com/cms/s/0/476fecaa-fb0c-11df-b576-00144feab49a.html#ixzz1oSLQdSS1.

[3] The quote has been retrieved from the following website: http://www.complianceweek.com/international-insider-trading-enforcement-showing-new-signs-of-life/article/187929/.