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Information asymmetry and the information content of insider trades: Evidence from the Indian stock market☆

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A B S T R A C T

This paper investigates a proprietary dataset of insider trades for Indian listed firms, where controlling ownership and business groups dominate. We show that the information content of insider trading is an inverted U-shaped function of controlling ownership. Further, we find that the information content of insider trading is lower when firms are affiliated with a business group. We also show that information production depends on the degree of information asymmetry between insiders and outsiders. Finally, we find that insider trades that occur prior to an earnings announcement have a larger impact on stock prices.

1. Introduction

A large body of studies has documented that insider trading conveys new information to the market. For instance, Seyhun (1986), and Lakonishok and Lee (2001) report positive abnormal returns following the public disclosure of insider purchases for the U.S. Similarly, Fidrmuc et al. (2006) find positive abnormal returns of insider purchases for the U.K. While an insider purchase conveys positive news about the firm's future, it is less clear what information an insider sale conveys. On the one hand, an insider sale may convey bad news about the firm's future. On the other hand, an insider sale may be less informative if it is made to meet the liquidity needs. A counter example of above studies is Eckbo and Smith's (1998) study, which finds that insiders of firms listed on the Oslo Stock Exchange do not earn abnormal profits.

Furthermore, Huddart and Ke (2007) show that the information advantage of an insider is driven by two factors. First is the uncertainty of firm value and second is the precision of an insider's private information. In this paper, we extend

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insider trading literature for emerging markets such as India, where poor investor protection[1] discourages informed trading, resulting in higher uncertainty of firm value (Fernandes and Ferreira, 2008, 2009; Kim and Shi, 2008). In this case, the information of insider trading should be more informative, even if an insider's information is less precise.

The informativeness of insider trading in emerging markets stems from two primary sources. First, corporate ownership structure in emerging markets is highly concentrated and is held directly by founders and family. These shareholders control firms more than their equity investment through cross-holding ownership, resulting in divergence between cash-flow rights and voting rights (Claessens et al., 2002). In contrast to developed nations, such complex ownership structure along with a weak legal enforcement system allows insiders to use firm resources to generate private benefits of control that are not shared by minority shareholders.[2] These firms therefore reveal less firm-specific information to camouflage the behaviour of controlling shareholders, which aggravates the degree of information asymmetry between insiders and outsiders (Attig et al., 2006). More importantly, concentrated ownership also provides an access of more precise information. We thus postulate that because of greater information asymmetry and access of more precise information, insider trading should convey more information. On the other hand, when concentrated ownership allows insiders to direct profit transfer for private benefits (Claessens et al., 2002), then insiders are more likely to avoid the litigation risk because of trading on private information, resulting lower information content of trading.

Second, we believe that the information content of insider trading could be affected by how much insiders can actually trade on their information.[3] If insiders are restricted to trade by regulations, the information content of insider trading would be smaller simply because they do not trade based on private information. In this case, the regulation to prohibit insider trading is perhaps only a response of Indian regulators. In India, the Securities and Exchange Board of India (SEBI) regulates insider trading activities, but insider trading prohibitions are limited, have rarely been enforced, and have had little apparent consequence of insider trading.[4] Because of such less stringent enforcement of regulations,[5] insiders can trade on private information, resulting in higher information content of insider trading in emerging markets than in developed markets. In addition, many Indian firms organize themselves as groups due to institutional voids associated with emerging markets (Khanna and Palepu, 2000). Firms affiliated to business groups tend to have information leakages because of complex intra-group transactions (Bertrand et al., 2002). We thus propose that a complex group structure along with information leakage should influence the transparency and trustworthiness of visible insiders' action, and impacts on how outsiders comprehend the insider trading information.

Studies related to emerging markets have been limited due to paucity of data. We use a proprietary dataset to examine the information content of insider trading for Indian firms. Our results document that the public disclosure of insider trading conveys new information to the market. In contrast to developed markets, we show that the public disclosure of insider sales is as informative as insider purchases. Our findings are consistent with the view that in an emerging market, with poor analyst following and an independent press, insider trading becomes a useful source of new information (Fernandes and Ferreira, 2009). We next find that concentrated controlling ownership is an important factor determining the information content of insider trading. Specifically, our results demonstrate an inverted U-shaped relationship between the information content of insider purchases (sales) and controlling ownership: It initially increases at a decreasing rate, and then begins to decrease when the percentage reaches beyond a certain threshold. Our results are consistent with the ownership literature that is a high controlling ownership allows insiders to exploit minority shareholders by trading based on private information. However, as the degree of ownership exceeds a minimal level needed for an effective control, the alignment effect may diminish the entrenchment effect. Therefore, insiders do not trade based on private information, leading to lower information content of insider trading. Moreover, we show that business group firms demonstrate less price adjustment after insider purchases. The novel aspect emphasized here is that group affiliation also exerts direct influence on the informativeness of insider trading.

Huddart and Ke (2007) suggest that the uncertainty of firm value and the precision of insiders' information both increase with the degree of informational asymmetry. Therefore, we next examine cross-sectional differences in the information content of insider trading by using various proxies of information asymmetry such as institutional ownership, the percentage of independent directors, price informativeness, and product market competition. Following Huddart and Ke (2007), we also use the price response to earnings announcements as a proxy of information asymmetry. Consistent with Peress (2010), we find that the product market imperfections improve stock market efficiency and thus the information content of insider purchases declines with industry concentration. Consistent with Gu and Li (2012), we show that price informativeness reduces the information content of insider purchases. Our results also exhibit that the market takes board independence into account while reacting on insider trading information. The abnormal returns of insider purchases are lower for firms

[1] The variation between U.S market and Indian market can be seen from the 2009 ranking of investor protection as reported by the Doing Business project of the World Bank. In this ranking, India stood at 44th position, whereas the U.S at 5th position. Furthermore, in the accounting disclosure transparency, reported by The World Economic Forum Global Competitiveness Report 2010-11, is stronger for U.S firm, compared to Indian firms.

[2] See, for example, Wurgler (2000) and Bertrand et al. (2002) for evidence from India.

[3] We thank the anonymous reviewer for suggesting this point.

[4] See for insider trading regulation, Beny, (2005), Bhattacharya and Daouk (2002)

[5] Mehta (2011) notes that several cases where the Securities and Exchange Board of India, Indian regulatory, has not imposed a serious penalty on the convict of insider trading. In one case involving insider trading at Reliance, she notes that while it would have been well within its powers to levy a penalty exceeding about US$250 million, whereas the actual penalty was only about US$500,000.