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Legal Insider Trading in Europe Makes the Case for Enforcement



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Evidence about the relative importance of private and public enforcement of securities laws for financial markets is inconclusive. The recently introduced Market Abuse Directive (MAD) (2003/6/EC) sets a European Union (EU) standard for regulation of insider dealing and market manipulation. Under Article 18 of the MAD, EU member states had to implement by October 12, 2004, local regulations that require the disclosure of corporate insider trading. The regulation represents a unique natural experiment that was introduced not in response to a specific case but as a mandate (exogenously) to EU countries (and Switzerland) simultaneously. This experiment allows us to examine the importance of public enforcement of the MAD on insider dealing across European countries.

We develop a public enforcement Insider Trading Index (ITE) that is based on very specific measures related to the public enforcement of the MAD. ITE combines regulators' formal legal powers, resource-based measures of public enforcement, and evidence on actual enforcement activities. Weaker MAD enforcement is expected to result in investor mistrust and, in turn, less reliable information being available to investors. Accordingly, we predict more positive abnormal returns after insider purchases and more negative abnormal returns after insider sales in countries with weaker public enforcement of insider regulation.

Our sample consists of 46,172 insider trading disclosures in Austria, Belgium, France, Germany, Italy, the Netherlands, and Switzerland, during the period January 1, 2006, to December 31, 2013. The number of sample companies underlying the number of director trades is 2,096. The average number of declared purchase transactions per company is 14 purchase and eight sale transactions. The number of insider purchases peaks during the recent financial crisis in 2008. The highest percentage of purchases relative to sales during the entire sample period is recorded in Austria (the lowest percentage is revealed in Switzerland).

Our results suggest that the sample country with the highest ITE index is Italy, followed by France, Belgium, the Netherlands, Austria and Germany, and Switzerland. Overall, countries with French legal origins (France, Italy, Belgium, and Netherlands) score significantly better on the ITE index than do their counterparts with German legal origins (Austria, German, and Switzerland). The above ranking contrasts with rankings in some previous studies that used proxies for private enforcement or did not specifically consider public enforcement of securities laws. Our results therefore highlight the importance of examining public enforcement activities and whether regulators actually exercise their powers by punishing offenders.

Insider purchase transactions tend to take place after a decline in abnormal returns and tend to create a significant positive price effect. This positive effect is more pronounced in countries with weaker public enforcement (lower ITE Index). Insiders also tend to adopt contrarian strategies when they sell shares of their own companies. The enforcement of insider trading regulation, however, played an important role for sale transactions only during the recent crisis period. The significant price impact of the insiders' transactions in countries with a lower ITE index provides a strong case for public enforcement of securities laws.

This post comes to us from Wolfgang Aussenegg at the Vienna University of Technology's Department of Finance and Corporate Control, Professor Ranko Jelic at the University of Sussex, and Robert Ranzi, also at the Vienna University of Technology's Department of Finance and Corporate Control. It is based on their recent article, "Corporate Insider Trading and the Short-Run Price Impact of Private Information in Europe," forthcoming in the Journal of International Markets, Institutions and Money and available here.

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