FINANCE AND ECONOMICS

Insider trading

The cost of inequity

NEW YORK

RELATED ARTICLES
South Africa gets tough on insiders

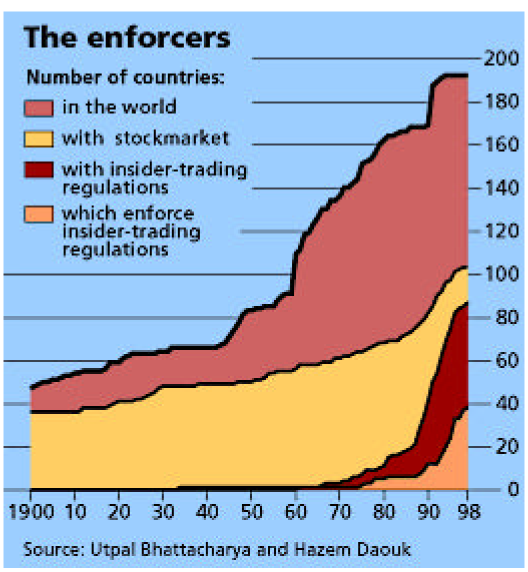
MORE ABOUT
Financial regulation

RESOURCES
Search archive

Links

TO MANY investors, insider trading remains one of those sins covered only by the eleventh commandment: thou shalt not get caught. Indeed, in much of the world, it is only recently that feathering your nest by trading on privileged information about a company has been seen as a crime. America banned most forms of insider trading in 1934—though enforcement since has often lacked vigour—but it did not become illegal until 1980 in Britain and 1994 in Germany. During the 1990s, the number of stockmarkets on which insider trading is a crime soared from 34 out of 79 markets to 87 out of 103.

This burst of legislative activity has allowed outside investors to compete on a more level playing field with insiders. Even so, economists disagree about whether banning insider trading has actually been good for the equity market. Some reckon that insider trading is actually the quickest way for information about companies to reach the market, and so produces share prices that better reflect firms' true values. Others reply that the possibility of being outfoxed by better-informed insiders makes shares riskier for outsiders, who are therefore not willing to pay as much, or may not buy at all.



Which of these views is right is explored in a new study by Utpal Bhattacharya and Hazem Daouk, two economists at Indiana University*. Using monthly data for all

103 stockmarkets (from 1969-98 for developed countries and 1988-98 for developing ones), they examined whether the existence of insider-trading laws lowered, or raised, the cost to companies of financing themselves by selling equity.

There is no perfect way to calculate the cost of equity. The two economists employed a crude but widely used formula: the average realised monthly return on a country’s main stockmarket index. On this measure, banning insider trading lowered the cost of equity. But then they re-crunched the numbers to take account of differences in liquidity between stockmarkets—the more liquid a market, the lower the cost of equity. They found that the existence of insider-trading laws no longer made a difference. The same was true if they took into account other variables: the degree to which a stockmarket was integrated into global capital markets, exchange-rate risk, and other shareholder-protection laws.

So insider trading is OK, then? Not necessarily. Drafting insider-trading laws is very different from enforcing them. To gauge the impact of enforcement, the paper uses the occurrence of an insider-trading prosecution as a proxy—since a lack of prosecutions probably indicates lax supervision and enforcement, rather than a lack of insider trading. Before 1990, only nine countries had ever prosecuted anybody for insider trading; America was the first in 1961. By 1998, the number had jumped to 38.

Even after adjusting for other differences, it turned out that those countries which enforced their insider-trading laws had a lower cost of equity. On average, enforcing insider-trading laws reduced the cost of equity by 5%. That may not seem like much: but 5% of total world stockmarket-capitalisation is around $1.75 trillion. For that, banning insider trading and then enforcing the rules seems well worth doing.

*“The World Price of Insider Trading”. Kelley School of Business, Indiana University working paper, January 2000. Available from ubhattac@indiana.edu.

LINKS

Click here to read a summary of the Insider Trading Act of 1998.

Top of page