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GLOBAL INVESTING: Few countries enforcing insider trading laws: A new study of the world's 103 stock markets reveals that just one-third have made a prosecution, writesAlison Beard

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By ALISON BEARD

Nearly 85 per cent of the world's stock markets have laws against insider trading but only one-third have enforced them. And in countries where no insiders have been prosecuted, companies pay an average of 5 per cent extra to raise capital, according to a new study.

"That is the price of honesty," said Utpal Battacharya, a finance professor at Indiana University's Kelley School of Business and co-author of the study, which will soon be published in the Journal of Finance. "Countries have to pay 5 per cent extra to their shareholders."

In a market where insiders with non-public information can trade freely, broker-dealers protect themselves by increasing their sell price and decreasing their buy price. This bumps up transaction costs, forcing traders to demand better returns. Mr Battacharya also argues that "controlling large shareholders could easily be tempted by management to make profits from stock tips rather than . . . from hard-to-do monitoring. Knowing this, (other) shareholders would demand a higher return on equity."

But laws are not enough, he said. Capital-raising costs go down and a country's credit rating goes up only after the first prosecution.

Mr Battacharya began his investigation of the world's 103 markets, with PhD student Hazem Daouk, after conducting similar research in Mexico. In that study, he found that A shares, which are held by only Mexicans, including corporate executives, were traded heavily before an important company announcement, while B shares, which are held by foreigners, saw less activity.

"In the US, when a takeover is announced the stock jumps up. It may have already gone up because there is about a 50 per cent leakage rate in the US, but in Mexico, it's 100 per cent," Mr Battacharya said.

Emerging markets mutual fund managers criticised the study, however, arguing that insider trading was not a significant problem. Mr Battacharya acknowledges that he set out to prove them wrong.

He spent one year gathering information from every world market - including the youngest (Tanzania), the oldest (Germany), the largest (the New York Stock Exchange) and the smallest (Guatemala). "I faxed, e-mailed, voice-mailed, slow-mailed each and every country to ask if they had insider trading laws and if they had enforced them," he said.

Controlling for other factors, such as company risk and market liquidity, he found that listed companies saved 5 per cent in countries where insiders had been prosecuted.

"You probably need one big insider trading case every year - someone getting caught," Mr Battacharya said, pointing to the US as a model. The Securities and Exchange Commission prosecutes about 40 to 50 insider trading cases a year. "They don't always succeed but they try very hard to keep it away," Mr Battacharya said. "And the US becomes the most liquid market in the world. It's a virtuous circle that more than pays for the enforcement costs."

In Europe, the situation is varied. Germany, which established its stock market in 1585 but only outlawed insider trading in 1994, has had only a few prosecutions. In France, many of the cases are politically motivated, Mr Battacharya said.

But the US has influenced other markets. "In the 1990s, the SEC has entered into some sort of club with the other securities commissions," Mr Battacharya said. "They are telling them, 'This is what you need to do to attract foreign capital.'"

The 81 emerging markets are slowly coming around, he said. "In the markets where only a few stocks are trading, they are just learning the institutional details. A few countries asked 'What is insider trading?'" A copy of The World Price of Insider Trading can be found at www.ssrn.com.