CORPORATE INSIDER TRADING AND THE SHORT-RUN PRICE IMPACT OF PRIVATE INFORMATION IN CONTINENTAL EUROPE

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Abstract

This study examines the information value of corporate insider transactions for a sample of 1,242 public traded companies located in seven continental European countries. Our results indicate that insiders reveal information to the public through their trading activities. Insiders tend to time their transactions, selling shares after stock price increases and buying shares after stock price decreases. Furthermore, we show that parameters like firm size, transaction size, and legal origin influence the stock price reaction to insider trades.

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1. Introduction

Insider trading occurs when corporate insiders, like e.g. managers or members of the supervisory board buy or sell stocks of their own company. The trading activities of these insiders are not forbidden, however, the use of insider knowledge in such transactions is illegal. To protect the public and to improve market transparency, the disclosure of corporate insider trading is an important aspect in a modern financial system. In continental Europe such regulatory needs became effective under the EU 'market abuse' directive.

Under article 18 of the EU 'market abuse' directive EU member states are forced to implement local regulations that require the disclosure of corporate insider trading till October, 12th 2004. The directive requires corporate insiders to immediately disclose their trades. The implementations specify "immediately" within the range of two to five days. The non EU-member state Switzerland implemented a similar regulation that closely follows the definitions of the EU regulation.

Previous empirical studies on insider trading highlight the ability of insiders (and to some extend also outsiders that follow insider transactions) to earn significant abnormal returns during the first weeks or even month after trading. This is true for early (see, e.g., Jaffe (1974), Finnerty (1976), or Seyhun (1986)) and also recent U.S.

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studies (like, e.g., Lakonishok and Lee (2001), Jeng et al. (2003), or Aktas et al. (2008)). The vast majority of previous work focuses on U.S. capital markets but comparable results are also documented for some European markets, like the UK (see, e.g., Pope et al. (1990), Gregory et al. (1997), and more recently Fidrmuc et al. (2006)), the Netherlands (see Biesta at al. (2003) and Aktas et al. (2007)), or Spain (see Del Brio et al. (2002)). Eckbo and Smith (1999) report zero or even negative abnormal returns for insider transaction in Norway.

The aim of this study is to analyze the information content of insider trading disclosures in seven continental European countries. Our sample comprises 16,488 legal insider disclosures from 1,242 continental European companies. We focus on insider trading disclosures in the following countries: Austria, Belgium, France, Germany, Italy, the Netherlands and Switzerland. In general, in these countries laws forcing insiders to disclose their trading activities came into effect only after the European Union Market Abuse Directive was transposed into national law by the member states. Our overall investigation period starts on July 1st, 2002 and lasts until December 31st, 2007.

Our study extends the literature on insider trading in several ways: First, we concentrate on insider trading in (continental) European countries, thus generating a better understanding of the effects of insider trading outside the U.S. and the U.K. We analyze how market participants react to the new information of insider trading disclosures and whether or not market participants change their perception of information contained in such disclosures.

2. Main Results and Discussion

This paper attempts to shed light on the market reaction following the disclosure of insider transactions in seven continental European countries. The research period ranges from July 1st, 2002 till December 31st, 2007. The legal obligation to disclose insider trades came into effect at different points in time in the seven countries covered by the study. Therefore, the insider trading data starts on different dates for each country: (1) Austria: May 2nd, 2005, (2) Belgium: May 22nd, 2006, (3) France: March 22nd, 2006, (4) Germany: July 1st, 2002, (5) Italy: January 1st, 2003, (6) the Netherlands: October 3rd, 2005, and (7) Switzerland: July 1st, 2005. Our dataset consists of more than 16,000 insider trading announcements in 1,242 (continental) European traded companies.

To empirically asses the market reaction following the disclosure of insider transactions we use an event study approach, as delineated in MacKinlay (1997) and in Campbell et al. (1997). We perform three types of statistical tests to assess the significance of cumulated abnormal returns (CARs): a parametric test as proposed by Boehmer, Musumeci, and Poulsen (1991), the Wilcoxon signed rank test and a proportion test.

Our results show that insider purchase transactions follow price declines and precede price increases. For our sample of 8,649 insider purchase transaction, we document an average CAR of -2.05% in the twenty trading days before the insider transaction disclosure, whereas the average CAR during the twenty trading days following the transaction is +0.40%. In contrast to findings for the U.S., selling transactions also seem to contain pricing relevant information. For the total sample of 7,739 insider sale transactions the average CAR is +1.61% for the last twenty trading days before the disclosure, however, CARs decline significantly after the disclosure of insider sale transactions. During the twenty trading days following the disclosure of

insider transactions we document CARs of -1.67%. Furthermore, we find that the legal origin of the countries in our sample can significantly contribute to explain the observable abnormal price reactions to insider trades.

Our results also reveal that in German law countries insider purchase transactions tend to disclose positive pricing relevant information, whereas this is not the case in French law countries. Also, the negative abnormal performance following insider sale transactions is primarily attributable to insider trades in German firms. This observation of a significantly negative abnormal price effect after German insider sale transactions is in line with previous studies investigating such deals, like, e.g., Betzer and Theissen (2007).

We further observe that the magnitude of abnormal price reactions to insider sale and purchase transactions declines over time. This might indicate an increase in pricing efficiency and a decreasing information asymmetry between corporate insiders and outside investors.

Large companies are supposed to be more information efficient than smaller companies, as they are more heavily followed by financial analysts and a have a larger fraction of institutional stockholders – facts that typically reduce information asymmetries. This assumption is confirmed by our findings, as we document that stock prices of smaller firms react stronger to insider trading disclosures than stock prices of larger firms. Insider purchase transactions in large companies are preceded by significant CARs of -2.09% in the twenty trading days before the transaction disclosure. In the twenty trading days after the transaction disclosure we find insignificant CARs of 0.04%. For the corresponding sale transaction our results reveal significant CARs of +1.25% twenty trading days before and significant CARs of -1.40% twenty trading days after the disclosure date.

For purchase transactions in small companies we find significant CARs of -2.01% during the twenty trading days before and significant CARs of +0.83% in the twenty trading days after the disclosure. For sale transactions in small companies we document significant CARs of +1.98% during the twenty trading days before and significant CARs of -1.94% in the twenty trading days after the disclosure.

To conclude, we show that the legal origin of a country influences the information content of legal insider trading. Insider purchase trades in German law countries reveal positive pricing relevant information, which is not the case in French law countries. We also find that insider trades in small firms tend to exhibit more pricing relevant information than insider trades in large firms. This observation is in line with the observation that larger companies have more efficient prices as they are followed by more analysts and are typically forced to provide more information to the public.

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