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73 Insider trading rules can affect attractiveness of country's stock markets

Assistant Professor **Laura N. Beny** joined the University of Michigan Law School in 2003. She earned her M.A. and Ph.D. in economics at Harvard University, her J.D. at Harvard Law School, and her B.A. in economics at Stanford University. At Harvard Law School, she won a prize for outstanding paper in law and economics for her empirical research on insider trading laws and stock markets across countries. Her research interests span law and economics, finance, economic institutions, and development. Beny is currently working on several empirical projects in law, finance and political economy, law firm economics, and comparative law. She also frequently speaks and writes on the Sudan. Beny is a research fellow at the William Davidson Institute at the Stephen M. Ross School of Business at the University of Michigan and a member of the American Law and Economics Association and the New York Bar. She served as a 2005-2006 National Fellow at the Hoover Institution, Stanford University. Before coming to Michigan, she practiced law in New York City, where she represented both private and pro bono clients.

76 Criminal justice and the 1967 Detroit 'riot'

Yale Kamisar, the Clarence Darrow Distinguished University Professor of Law Emeritus at the Law School, is a nationally recognized authority on constitutional law and criminal procedure. A graduate of New York University and Columbia Law School, he has written extensively on criminal law, the administration of criminal justice, and the "politics of crime." He is author of *Police Interrogation and Confessions: Essays in Law and Policy* and co-author of *Criminal Justice in Our Time*, and *The Supreme Court: Trends and Developments* (five annual volumes). He wrote the chapter on constitutional criminal procedure for *The Burger Court: The Counter-Revolution That Wasn't*, *The Warren Court: A Retrospective*, and wrote the chapter on police interrogation and confessions for *The Rehnquist Legacy*. He is also co-author of two widely used casebooks: *Modern Criminal Procedure: Cases, Comments & Questions*, all 11 editions, and *Constitutional Law: Cases, Comments & Questions*, all 10 editions. In addition, he has written numerous articles on police interrogation and confessions; right to counsel; search and seizure; and euthanasia and assisted suicide and is widely quoted on these subjects. Professor Kamisar taught at the University of Minnesota Law School from 1957-64 and joined the University of Michigan law faculty in 1965. Although he retired from teaching at Michigan Law in 2004, he continues to teach at the University of San Diego School of Law in California.

Insider trading rules can affect attractiveness of country's stock markets

by **Laura N. Beny**

The following essay is based on testimony the author delivered to the U.S. Senate Judiciary Committee on September 26, 2006.

The academic debate about the desirability of prohibiting insider trading is longstanding and as yet unresolved. Until Henry Manne's 1966 book, *Insider Trading and the Stock Market*, the debate centered on whether insider trading is unfair to public investors who are not privy to private corporate information. However, the fairness approach is malleable and indeterminate and thus does not lend itself to clear-cut policy prescriptions. Since Manne's book, the focus of the debate has been on the effect of insider trading on economic efficiency. Manne argued that, contrary to the prevailing legal and moral opinion of the time, insider trading is desirable because it is economically efficient and thus ought not to be regulated. In contrast, Manne's critics argue that insider trading is inefficient and thus ought to be regulated.

In brief, legal scholars who believe that insider trading is efficient and thus ought not to be prohibited maintain that insider trading increases managers' (and other insiders') incentives to behave in the interest of stockholders; makes stock prices more informationally efficient (that is, more accurate); and/or does not decrease the liquidity of the stock market. In contrast, legal scholars who believe that insider trading is inefficient and thus ought to be prohibited argue that insider trading reduces managers' (and other insiders') incentives to behave in the interest of stockholders; makes stock prices less informationally efficient (that is, less accurate); and/or decreases stock market liquidity.

The legal academic literature on insider trading suffers from a few significant shortcomings. One problem with this literature is that the scholarly debate fails to identify a specific efficiency locus. The academic inquiry varies from examinations of the narrow effects of insider trading on efficiency at the firm level (so-called agency theories of insider trading) to work studying the broader effects of insider trading on stock market efficiency (so-called market theories of insider trading). It is possible, however, that insider trading may enhance efficiency within the firm, but that markets in which insider trading is permitted are



thereby less efficient in the aggregate. Researchers who focus their studies at different levels and report different results could be talking past each other.

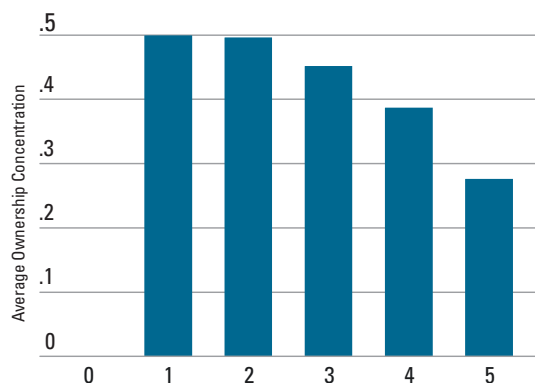
A second, major shortcoming of the law and economics literature on insider trading is that it is insufficiently grounded in empirical evidence. Beginning with Manne's seminal argument, legal academic scholarship on insider trading has been largely speculative and theoretical. Moreover, few scholars sought to examine the impact of insider trading rules in a comparative context. However, without variation in insider trading rules and enforcement, one cannot test causal hypotheses about the effects of such rules and their enforcement.

Summary of empirical findings

In contrast to most of the existing legal scholarship on insider trading, my research is empirical and comparative. In the study "*Insider Trading Laws and Stock Markets Around the World*," which I summarize in this brief written testimony, I investigate whether insider trading laws and enforcement are systematically related to stock market performance across countries. I formulate three testable hypotheses, which are that countries with more stringent insider trading laws have (a) more widespread equity ownership; (b) more informative stock prices; and (c) more liquid stock markets, other things, including enforcement history and potential, equal. To test these hypotheses, I constructed an index of the stringency of insider trading laws for 33 countries as of the mid-1990s.

Using simple correlations and multivariable regression analysis, I find that countries with more stringent insider trading laws have more dispersed equity ownership; more liquid stock markets; and more informative stock prices, consistent with the formulated hypotheses. The following three figures, excerpted from my study “*Insider Trading Laws and Stock Markets*,”

Figure 1: Average Ownership Concentration Plotted Against Insider Trading Law Index



demonstrate these findings visually. Figure 1 shows that the countries in my sample that have more stringent insider trading laws tend to have lower average equity ownership concentration (that is, more dispersed share ownership) among their 10 largest non-financial firms, where ownership concentration is measured as the equity ownership stake of the three largest shareholders in the 10 largest private non-financial firms in an economy.

Figure 2: Average Stock Price Synchronicity Plotted Against Insider Trading Law Index

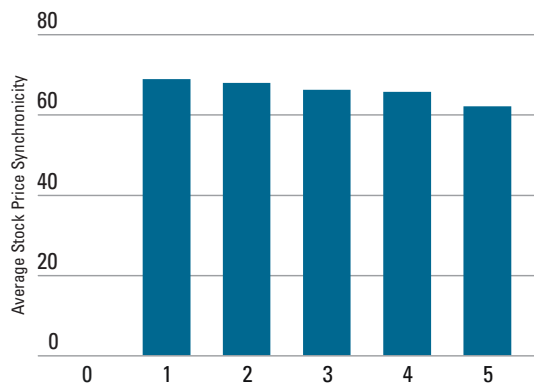
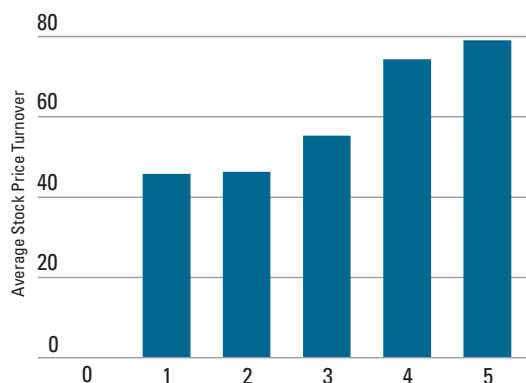


Figure 2 illustrates that the countries with more stringent insider trading laws also tend to have more informative stock prices, as measured by stock price synchronicity. (Stock price synchronicity is a measure of the degree to which the stock prices of different firms move together, with greater co-movement suggesting that stock prices are less informative about firm-specific information).

Finally, Figure 3 shows that the countries with more stringent insider trading laws tend to have greater average stock market turnover (a measure of stock market liquidity) than countries with less stringent insider trading laws.

Figure 3: Average Stock Market Turnover/Liquidity (1991-1995) Plotted Against Insider Trading Law Index



I confirm these patterns when I conduct multivariable regression analysis to control for other factors, including past enforcement history and enforcement potential. Furthermore, my regressions strongly suggest that *the possibility of stringent criminal or monetary sanctions, rather than the breadth of the insider trading prohibition, is the more salient feature of countries' insider trading laws*. Criminal and civil sanctions are more frequently significant than the scope of the insider trading prohibition in the regressions that I report in the article. Stringent public enforcement also seems to be more important than private enforcement.

Implications of empirical research for the U.S. insider trading debate

My results are consistent with (but do not prove) the claim that insider trading laws have a positive impact on stock markets. More liquid stock markets and more accurate stock prices reduce the overall cost of equity capital and improve the efficiency of capital allocation, respectively. Private parties would be unlikely to give adequate consideration to these external benefits, if insider trading were left to private contracting (that is, if firms and shareholders were permitted to set the firm's insider trading policy in place of insider trading regulation). My findings thus support the case for public regulation and correspondingly weaken the case for deregulation of insider trading. Furthermore, to the extent that insider trading regulation encourages more accurate stock prices and greater stock market liquidity, regulation might indirectly ameliorate corporate agency problems, as more accurate stock prices and greater liquidity facilitate improved corporate governance and the market for corporate control. The United States has the most stringent insider trading rules and enforcement in the world and recent empirical evidence, including my own, suggests that this might be at least one reason why investor confidence is greater in our stock markets than in many other stock markets of the world. If insider trading laws are detrimental, as Professor Manne and others have posited, the patterns I find would have been unlikely.

It is premature, however, to claim that the debate between proponents and opponents of insider trading laws has now been empirically resolved. My results must be viewed cautiously for several reasons. One reason for caution is the crude nature of the available variables and the small sample of available countries. It is some consolation that these limitations might be expected to reduce the likelihood of finding significant relationships, but they nonetheless suggest a need for cautious interpretation. Finally, although my empirical results show a significant relationship between insider trading laws and various measures of stock market performance, they do not prove causality.

The appropriate conclusion to reach from this research is not that the arguments of proponents of insider trading regulation have been proven to be sounder than the arguments of those who criticize such regulation, but rather that there is greater reason to believe in their soundness than there was before this study was conducted. If insider trading laws are detrimental, as Professor Manne and others have suggested, the patterns I find would have been improbable.

Further empirical research on this issue is warranted, such as the assembly of more adequate cross-sectional data from a broader range of countries and over a longer range of time. My research is but a first step. It can help to resolve the theoretical conflict (and perhaps contribute to the articulation of a more coherent insider trading legal doctrine and policy in the United States) only if consistent empirical work follows.