Testimony

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on Unlawful Insider Trading

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Evidence on Insider Trading Laws and Stock Markets

Chairman Specter and Members of the Senate Judiciary Committee: Thank you for inviting me to submit written testimony to your hearing on unlawful insider trading. I am an Assistant Professor of Law at the University of Michigan Law School, where I teach courses on Corporate Law, Corporate Finance, International Finance, and Stock Market Development. Before joining Michigan Law School in 2003, I practiced corporate law at Debevoise and Plimpton LLP in New York City.

I have conducted several empirical research studies on insider trading laws and their enforcement across countries. In this testimony, I present a brief overview of the academic debate about insider trading and its regulation and a summary of some of my research findings. I conclude by discussing the implications of my research for the insider trading debate in the United States.

1. Overview of the Insider Trading Debate

The academic debate about the desirability of prohibiting insider trading is long-standing and as yet unresolved. Until Henry Manne’s 1966 book, *Insider Trading and the Stock Market*,¹ the debate centered on whether insider trading is unfair to public investors who are not privy to private corporate information.² However, the fairness

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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 antifraud provisions [of U.S. securities laws] are said to serve principally a protective function – to prevent overreaching of public investors – and only peripherally an efficiency goal”).


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.

2. Summary of Beny’s 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


6 Beny, Insider Trading Laws and Stock Markets, id.
formulated hypotheses. The following three figures, excerpted from my study “Insider Trading Laws and Stock Markets,” 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.

**Figure 1: Average Ownership Concentration 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).
Figure 2: Average Stock Price Synchronicity Plotted Against Insider Trading Law Index
Finally, Figure 3 shows that the countries with more stringent insider trading laws tend to have greater average stock market turnover (a measure of 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.\(^7\) 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

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\(^7\) Given the necessary brevity of my written testimony, I do not report my regressions here. For greater detail and discussion, please refer to Beny, *Insider Trading Laws and Stock Markets*, id.
regressions that I report in the article. Stringent public enforcement also seems to be more important than private enforcement mechanisms.8

3. Implications of Beny’s 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

8 See Beny, Do Insider Trading Laws Matter?, supra note 5.
of proponents of insider trading regulation have been shown to be sounder than the arguments of those who criticize such regulation, but rather that there is somewhat more reason to believe in their soundness than there was before this study was conducted. There is also need for further empirical research into these issues, including the assembly of more adequate cross-sectional data sets. My research is but a first step. It will help resolve the theoretical conflict (and perhaps contribute to the articulation of a more coherent insider trading doctrine in the United States) only if additional empirical work follows.