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Full Length Research Paper

The sun side of insider trading: An Ethical perspective by financial performance analysis in Hong Kong

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Insider trading has been a hot topic in financial research. However, the business ethics literature questions the societal value of insider trading. In this study, I examine how insider trading may benefit all shareholders instead of channeling wealth to the insiders only. Using 7,885 firm-year observations in Hong Kong, the author finds that there is a positive relation between annual return and abnormal annual return with insider trading activity. This study shows evidence that insider trading is beneficial to society by providing correctional signal to the market about the firm value and increasing shareholders wealth.

Keywords: Agency problem; Business ethics; Corporate governance; Ethics; Financial performance; Insider trading; Shareholder

INTRODUCTION

Insider trading has been a controversial issue. Some countries disallow insider trading completely by making it illegal; some allow but impose different trading and reporting restrictions. Through the years, there have been calls from policy-makers to prohibit insider trading to create a more equitable playing field by disallowing insiders gaining profits at the expense of outsiders. Some academia shows that insider trading provides signals to make the market more efficient. Some practitioners suggest that insider trading allow the insiders to make a market of their firms' shares to improve liquidity.

Many economists argue that restricting insider trading reduces the adverse selection problem in a firm's securities (e.g., Fishman and Hagerty, 1992), producing cost-of-capital benefits for the firm. However, others argue that restrictions on insider trading impose costs on insiders and on the firms that contract with them (e.g., Manne, 1966; Carlton and Fischel, 1983). Various studies examine the information content of legally disclosed insider trading (e.g., Moore, 1990; Werhane, 1989). Seyhun (1992) uses archival data on insider trades to address whether or not increased sanctions are effective deterrent to insider trading and shows that increased sanctions do not decrease the incidence of insider trading. Experimental markets have been used to assess whether individuals with insider information can achieve abnormal gains (Marsden and Tung, 1999). Some studies report that insider trading is an economic issue rather than a moral issue and that it increases shareholder wealth and has social utility (Ma and Sun, 1998). A counter argument says that even if overall wealth is increased, it is still unethical if it is unfair to any individuals (Snoeyenbos and Smith, 2000).

Insider trading is a common phenomenon in many even well-developed economies and it attracts increasing attention and scrutiny by regulators, investors and general public (Bhattacharya and Daouk, 2002). There are different arguments for and against insider trading activity. Insiders are able to earn profits by using price-sensitive information. The use of price-sensitive information to earn profits at the expense of others is one of the major reasons put forward by the regulators to restrict insider trading. Outsiders such as analysts and investors attempt to share the "insider profits" by following the trading behaviors of insiders. The academia suggest that insider trading is a signal of firm's value and helps quicker price discovery in the market and hence such kind of informed trading should be encouraged rather than prohibited (e.g., Cornell and Sirri, 1992). Through the years, the pros and cons about the insider trading have aroused a debate among different market-players. Insider trading remains a controversial issue to the regulators whether it should be strictly prohibited, regulated or allowed without restriction. Whenever new rules relating to insider trading are proposed, public attention would be stimulated.

In Hong Kong, insider trading is an allowed but regulated activity. Insiders can trade their firms' shares but have to make disclosure within 3 business days from their transaction day. There is another restriction that insiders cannot trade in one month (blockout period) prior to announcement of corporate results (annual and interim). In 2008, Hong Kong Exchanges (HKEx) announced a stricter constraint to extend the blockout period. Owing to the public pressure from some companies expressing strong opposition against the proposed rule on December 29, 2008, HKEx announced in January, 2009 to shorten the proposed annual blockout period from 7 to 3 months. Under the "modified" new rule, insiders are just prohibited from trading 2 months and 1 month before the annual and interim corporate results, respectively. This incident provides a further motivation of this study to examine the positive impacts of insider trading in Hong Kong.

In this study, I hypothesize that insider trading is beneficial by providing a correctional signal to the market about the correct share price. I find that firms with insider trading have higher share price than firms without. The findings of the pros about insider trading may be useful for the regulators to devise proper trading and reporting requirements to balance the interests of different market-players or stakeholders (including firms, insiders, investors, the general public, etc.).

Literature review

Insider trading continues to be a research focus as there are unresolved controversies that have implications for efficient market theory and regulatory policy. Informed trading affects informational efficiency of the market as price incorporates insider information. Previous studies argue that insider trading imposes negative impacts on the market as insiders get profits at the expense of outsiders (Jeng, Metrick and Zeckhauser, 2003; Fishe and Robe, 2004; Jaffe, 1974; Finnerty, 1976; Seyhun, 1986; Werhane, 1989). However, the release of private information by the insiders also helps promote price adjustment and market efficiency as the inside information can be incorporated into the share price (Seyhun, 1986; Lin and Howe, 1990). In the discussion below, I focus initially on the positive impacts of insider trading.

Insider trading occurs if an insider uses material, nonpublic (i.e. not openly available) information about a corporation in a securities trade. This sort of activity is generally prohibited by securities regulation. Its prohibition has been the subject of an important debate since the 1960s over developed economies. One of the most famous arguments against the prohibition of this kind of behavior is that insider trading represents the most appropriate compensation scheme to reward the entrepreneurial activity of insiders. Therefore, it may be the reason why some corporations allow their insiders to use inside information in order to stimulate their entrepreneurial and innovative activity for company growth (Manne, 1966).

Manne's (1966) second anti-regulation argument is that insider trading improves the alignment of interests between outside claimants and management by allowing managers to profit from the appreciation in firm value that their efforts stimulated. Accordingly, insider trading can serve as an economically sound and efficient compensation scheme for managers. This type of behavior is particularly useful for incentivizing entrepreneurial activities because it encourages managers to take risks in the pursuit of innovation (Manne, 2005). Such compensation schemes directly benefit shareholders because firms can pay lower salaries without sacrificing innovative behavior.

Carlton and Fischel (1983, p. 869-71) suggest a further refinement of Manne's (1966, 2005) compensation argument. They likewise believe advance payment contracts fail to compensate agents for innovations. The firm could renegotiate these contracts later to account for innovations, but renegotiation is costly and thus may not occur frequently enough to provide appropriate incentives for entrepreneurial activity. Carlton and Fischel (1983) further suggest that one of the advantages of insider trading is that an agent revises his compensation package without renegotiating his contract. By trading on the new information, the agent self-tailors his compensation to account for the information he produces, increasing his incentive to develop valuable innovations. Because insider trading provides the agent with more

certainty of reward than other compensation schemes, it also provides more incentives.

Large shareholders often play a valuable monitoring role (see, e.g., Bhide, 1993; Demsetz, 1986; Shleifer and Vishny, 1986). However, they must be sufficiently compensated for that and for the risks associated with holding undiversified portfolios. A potential compensation mechanism is insider trading (Bhide, 1993; Demsetz, 1986). Permitting insider trading may therefore encourage large shareholding by active investors, whereas legally prohibiting insider trading may have the opposite effect (Bhide, 1993; Demsetz, 1986).

Is active insider trading always unethical?

Some studies (e.g., Lawson, 1988; Moore, 1990) already indicated the possible establishment of a permissible legal form of insider trading on a contractual basis among the company, its shareholders and its employees. Yet some forms of insider trading are indeed perfectly legal (Shell, 2001) and hence some kinds of insider trading are not unethical. In other words, there is a widespread misperception on the part of the public about insider trading. McGee and Block (1992) discuss the arguments in favor of insider trading and claim that the overall impact of insider trading is positive. Arguments in favor of insider trading are that insider trading is not wrong. According to McGee and Block (1992), St. Thomas Aquinas believes "there is no moral duty to inform a potential buyer that the price of the good you are trying to sell is likely to change in the near future" (p. 221). Thus, insider has no moral duty to disclose that a price change occurs when the non-public information becomes publicly known. Next, McGee and Block (1992) argue that insider trading is not fraudulent because there is no loss to the less informed parties who are not involved. Without loss, there can be no fraud. However, this does not take into account the opportunity cost incurred because of future price changes. That said, no rights are violated, thus the act is not unjust. The rights of non-insiders are not violated because they receive a higher price for their stock. If a corporation believes its rights have been violated, it still has other legal remedies available. McGee and Block (1992) stress that "if the transaction is not fraudulent and the inside trader is not violating anyone's property rights in information, there is nothing unethical about the practice" (p. 226).

Besides, two basic philosophical approaches have been used to determine whether insider trading is ethical – the utilitarianism and rights-based approaches. The utilitarian approach, which is subscribed to by the vast majority of economists, views an action as being good if the result is being the greatest good for the greatest number (Bentham, 1781/1988; Mill, 1861/1979; Yunker, 1986). They would call it a positive-sum game if the benefits exceed the costs or if the good exceeds the bad. In the case of insider trading, they might consider whether there has been a breach of fiduciary duty. If that were the case, they might conclude that insider trading is unethical even if it would otherwise meet the utilitarian test. However, it should be pointed out that pure utilitarians would not arrive at this conclusion. They would take breaches of fiduciary duty into account but they would not automatically conclude that breaches of fiduciary duty make insider trading unethical. They would include it in the equation when attempting to determine whether the gains exceed the losses or whether the act still results in the greatest good for the greatest number even if there has been a breach of fiduciary duty. If efficiency increases despite the fiduciary duty breach, the argument could be made that the act was still ethical from a utilitarian perspective. Importantly, Moore (1990) pinpoints that notwithstanding the significance of fiduciary duty for business management, insider trading could still be possible with changes in contractual relationship.

The other approach to analyzing public policy issues is the rights-based approach, which focuses on the issue whose rights are violated. If someone's rights are violated, the act is automatically wrong, even if the result would be a positive-sum game. Manne (1966) mentions that if insider trading is a crime, it is a victimless crime, which does not result in the violation of the rights of anyone.

The main argument supporting insider trading is therefore efficiency. Trading on inside information causes information to be released into the marketplace the sooner rather than the later possible, thus causing stock prices to move in the right direction quicker than would otherwise be the case. Studies by Meulbroek (1992), Cornell and Surri (1992), and Chakravarty and McConnell (1997) support this argument.

Is insider trading fraudulent?

Whether insider trading is fraudulent is questionable. Fraud can be perpetrated in three ways, either by selling one thing for another or by giving the wrong quality or quantity (Dalcourt, 1965). A more modern definition is "intentional deception to cause a person to give up property or some lawful right" (Guralnik, 1964). A typical case of insider trading occurs when a buyer with inside information calls his stock broker and tells him to buy, knowing that the stock price is likely to rise as soon as the inside information becomes public. In this case, the buyer does not deceive the seller into giving up property. Indeed, the buyer does not even know who the seller is, and the seller would have sold the stocks anyway, anonymously, through the same broker. The seller's action would have been the same whether an inside trader is the other party to the transaction or not. If the

inside trader has not purchased the stock, someone else would have. Yet this "someone else" would not be accused of reaping unjust profits, even if the identical stocks are purchased for the same price the insider would have paid. Therefore, insider trading does not seem to fit the definition of fraud, so there does not seem to be anything fraudulent about it.

Based on this argument, an insider who knows the stock price is likely to rise in the near future has no moral duty whatsoever to inform potential sellers of this fact. Where there is no moral duty, certainly there should be no legal duty either. In fact, the U.S. Supreme Court has ruled at least twice that those in possession of non-public information do not have a general duty to disclose the information to the marketplace (Chiarella, 1980; Dirks, 1983). Macey (1988) has also spoken on this point.

In fact, the academic literature recognizes that insider trading does not result in any harm to any identifiable group of persons (Manne, 1985) and those who sell to inside traders may actually be helped rather than harmed the market because they received a better price, so it appears illogical to allow them to sue for damages if, in fact, there are actually no damages (Carlton and Fischel, 1983; Easterbrook, 1981; Morgan, 1987). From the perspective of utilitarian ethics (Crisp, 1997; Goodin, 1995; Shaw, 1999), sellers are no worse off as a result of having sold to an insider than they would have been if they have sold to a non-insider. Thus, there is nothing wrong with the practice from the perspective of utilitarian ethics.

Insider trading

Motivation and incentive

One of the arguments of Manne (1966) in favor of insider trading is that it is a form of executive compensation for entrepreneurial efforts. Similarly, Easterbrook (1985) argues that permitting insider trading would increase the likelihood that employees will act in the interest of the shareholders and their firms in an efficient way. It is an alternative form of compensation that makes it possible to pay a lower base salary. It is a way to save on payroll costs and does not cost the company anything, because all it involves is allowing an executive to use inside information for personal gain from trading. To the extent that it reduces the amount of cash outlay that a company must pay to retain an executive, it is a way to keep compensation costs down. But this line of reasoning has been criticized.

One criticism is that allowing executives to trade on inside information is not necessarily limited to those who are entrepreneurs within the organization. Executives who do not have entrepreneurial skills may also engage in insider trading and may do so at a time when the company is actually losing money. Rather than being based on good performance, insider trading may be used to compensate executives when the company is doing poorly, prior to release of such information. The rewards are not necessarily tied to good performance. For example, if a company's stock is about to drop in price as a result of managerial incompetence, the very insiders who caused the stock to fall can gain as a result of their inside information by selling their stock before information becomes disseminated to the general investing public. Bernardo (2001) sees the right to trade on insider information as a contractual problem of allocating property rights between shareholders and stakeholders. Shaw (1984) holds similar views. Allowing insiders to deal in insider information has also been considered as a kind of compensation, a salary supplement or a bonus to be given as a reward for performance.

Manne (1966) and Carlton and Fischel (1983) argue that insider trading aligns insiders' motives with those of shareholders. Although some respond that insider trading offers equal incentives to improve or worsen stock price performance (because insiders can profit from a knowledge of good or bad news), restrictions on short-selling and reputation and litigation concerns imply that insider trading is more profitable when the firm experiences good performance (Hue and Noe, 1997). Insiders who wish to profit from their trading find the most success is to increase firm value. In this regard, the dark side of insider trading would be less influential by its nature.

Insider trading as a path to competitive advantage

Insider trading may be an effective incentive mechanism for those who have strategic knowledge for the business. Specifically, insider trading favors those who possess the most significant knowledge about the extent and durability of the competitive advantage. In this context, causal ambiguity may hinder the effectiveness of traditional reward systems because it is difficult to identify key players and measure business performance (Coff, 1997). However, allowing insider trading would encourage individuals with private knowledge of a potential innovation to purchase shares. This, in turn, provides them with an incentive to transfer and combine the knowledge so that the firm can realize the economic potential of the private knowledge.

In essence, insider trading may create an invisible hand in economic sense to guide incentives to the most knowledgeable employees, who are also in the strongest position to create a sustained competitive advantage for the company. It is not necessarily hard to consider how this invisible hand might be more efficient than the visible hand of managers attempting to design incentives amid poor information and performance measures.

Furthermore, as an incentive mechanism, the direct cost of insider trading may be lower than the conventional forms of compensation. If managers perceive that they deserve more of the economic rent and insider trading is prohibited, they may demand the economic rent in the form of higher pay or benefits (Manne, 1966). In other words, insider trading may substitute other forms of economic rent appropriation that are quite costly to shareholders since they directly lower net income. That is, the traditional compensation directly reduces net income since it is to be paid out as an expenditure of the company. Stock-based compensation may dilute the ownership, not being favourable to shareholders, and lead to a liability that is increasingly recognized in financial reporting. In contrast, allowing insiders to use their own resources to purchase existing stock imposes little to no direct cost on shareholders.

The agency problems

Some argue that letting insiders to trade on inside information gives rise to agency problems that shareholders would be unable to resolve. No firm should be authorized to allow insider trading because shareholders are not able to control such activity of their insiders (Easterbrook, 1981, 1985). The insider-trading-as-an-agent problem argument has two folds. The first focuses on the negative incentives that insider trading may create in manager's behaviors. The perspective of trading on inside information may invite them to undertake inefficient decisions that harm shareholders. This aspect is directly related to the issue of corporate governance, namely, how shareholders can "control" manager's activity. Thus, a regulated insider trading activity could be a direction towards resolving this issue. The second is related to the issue of contract enforcement and how shareholders can provide incentives for managers to respect their contract. When shareholders contractually prohibit insider trading, they may not be able to enforce the contracts because of the nature of insider trading, which is difficult to detect. Given the high cost of enforcement which in turn generates less economic profits, a better orientation for society may be to resolve the issue from a practical angle with due consideration to ethical concerns, i.e. without undermining the importance of business ethics.

Can insider trading benefit both parties?

Much of the scholarly literature on insider trading involves the question whether and to what extent insider trading is harmful. A number of prominent law and economics scholars have argued that, in fact, insider trading makes the market more efficient, by causing market prices to reflect more complete information about the value of the traded securities than otherwise would be possible, and that insider trading therefore ought not to be criminalized at all. If managers are able to use private information to obtain such "incentivizing" compensation, then they will not have such perverse incentives. Stocks are perpetual, so there is no incentive for executives to "game" the value of the stock price at any pre-specified point in time. Instead, managers and the corporation would be best served by pursuing strategies that would optimize the long-term value of the firm, thereby maximizing the value of their equity holdings (Easterbrook, 1985; Hu and Noe, 1997).

When insider trading is permitted, managers will reduce their salary demands by an amount equal to the expected gain from insider trading, therefore benefiting the shareholders who may then pay lower salaries to the managers (Macey, 1991). Moreover, some studies have pointed out that the prohibition on insider trading does not benefit the shareholders because the ban does not transfer the value of the information to the shareholders, but rather to justprofessional investors (Haddock and Macey, 1987). Consequently, the prohibition on insider trading is a loss to the shareholders and other stakeholders (including employees) as groups.

THE STUDY

DATA AND METHODOLOGY

To address this thematic topic, I hypothesize that insider trading is beneficial by providing a correctional signal to the market on the company prices.

Data

In this study, there are two types of insiders: directors and substantial shareholders (who hold shares of 5% or more in a firm). According to the listing rules of the Hong Kong Exchanges (HKEx), insiders who trade their firms' shares have to make disclosure on the "Securities (Disclosure of Interest) Summary" within 3 business days (this 3-day requirement was changed from a 5-day requirement in April 2003) from their transaction day. I collected the data of directors' dealings and substantial shareholders' dealings from the HKEx which reported the inside transactions of directors and substantial shareholders and made them available for public use. Although there are different types of inside transactions which are made by the insiders, for example, exercise of options, scrip dividends and open market sale and purchase. I use those transactions which increase or decrease the shareholding through the open market purchase or sale of shares made by the insiders as inside transactions for

Table 1. Descriptive Statistics (2000-2008). *DirD* is a dummy coded 1 if the firm has directors trading their firms' shares and 0 otherwise. *SubstanD* is a dummy coded 1 if the firm has substantial shareholders trading their firms' shares and 0 otherwise. *InsiderD* is a dummy coded 1 if the firm has insiders (either directors or substantial shareholders) trading their firms' shares and 0 otherwise. *Ret* is the annual returns of sample firm. *AbRet* is the difference between annual firm return and annual market return proxied by Hang Seng Index return. *LnSize* is log of firm market capitalization. *DebtRatio* is ratio of debt to total assets.

	Dummy Code = 1	Dummy Code = 0	Mean	Median	Standard Deviation	Min	Max
DirD	692	7193					
SubstanD	1234	6651					
InsiderD	1372	6513					
Ret			-0.1301	-0.0544	0.7665	-2.9874	2.9832
AbRet			-0.1161	-0.0933	0.6295	-2.8037	2.6872
LnSize			6.4799	6.2109	1.9155	1.5147	14.8316
DebtRatio			0.1972	0.1446	0.2692	0.0000	4.7298

analysis purpose (Lin and Howe, 1990). The sample period is between 2000 and 2008.

Methodology

To estimate the magnitude of the share price reactions of the firms with insider trading, event study methodology was used in my study. I classify the sample for firm with and without directors' dealings and substantial shareholders' dealings. *DirD* is a dummy coded 1 if the firm has directors trading their firms' shares and 0 otherwise. *SubstanD* is a dummy coded 1 if the firm has substantial shareholders trading their firms' shares and 0 otherwise. *InsiderD* is a dummy coded 1 if the firm has insiders (either directors or substantial shareholders) trading their firms' shares and 0 otherwise. *Ret* is the annual returns of sample firms. The inside-buyers earn profits from purchase when the share price increases and inside-sellers avoid loss (earn profits) from sale when the share price decreases. Therefore, in order to aggregate the total returns for both the insiders' "Purchase" and "Sale", the returns of the "Sell" transactions are multiplied by –1.

The abnormal return (*AbRet*) for sample firm is defined as:

$$AbRet = (Ret - MR) \times \theta \quad (1)$$

MR is the market returns, proxied by the return from movements in Hang Seng Index. θ is a variable for the direction of trade which takes the value of +1 if the trade j is a "Buy" transaction and –1 if the trade j is a "Sell" transaction.

I examine the relation between share price reaction and presence of insider trading in the following model:

$$Ret = \alpha_0 + \beta_1\ InsiderV + \beta_2\ LnSize + \beta_3\ DebtRatio + \beta_i \sum_i Year_i + \beta_j \sum_j Industry_j$$

$$AbRet = \alpha_0 + \beta_1\ InsiderV + \beta_2\ LnSize + \beta_3\ DebtRatio + \beta_i \sum_i Year_i + \beta_j \sum_j Industry_j$$

InsiderV represents the different versions of insider trading, *InsiderD*, *DirD* and *SubstanD*. *LnSize* represents firm size which is measured by log of firm market capitalization. *DebtRatio* is ratio of debt to total assets, which is a measure of firm leverage. $Year_i$ and $Industry_j$ are year dummies and industry dummies which are included in the model to control for year and industry fixed effects.

EMPIRICAL RESULTS

The descriptive statistics of the variables are reported in Table 1. Over the sample period between 2000 and 2008, there have been 7,885 firm-year observations. Of them, there are 692 directors' dealings (*DirD*) and 1,234 substantial shareholders' dealings (*SubstanD*). As some directors may also be the substantial shareholders (the case for those directors who hold a firm's position and shares of 5% or more of the firm), the total inside transactions (*InsiderD*) are 1,372. The mean *Ret* and mean *AbRet* are -0.1301 and -0.1161, respectively. (Table 1)

In Table 2, I compare *Ret* and *AbRet* of the subsamples with and without inside transactions (*InsiderD*, *DirD* and *SubstanD*) using parametric and non-parametric tests. I find that the firms with their directors and substantial shareholders trading their firms' shares earn higher return (*Ret*) than those without inside transactions. The difference in *Ret* between the subsmaples of *InsiderD* vs non-*InsiderD*, *DirD* vs non-*DirD* and *SubstanD* vs non-*SubstanD* are significant at 0.01 level for both parametric and non-parametric tests.

Table 2. Sample Comparison. *DirD* is a dummy coded 1 if the firm has directors trading their firms' shares and 0 otherwise. *SubstanD* is a dummy coded 1 if the firm has substantial shareholders trading their firms' shares and 0 otherwise. *InsiderD* is a dummy coded 1 if the firm has insiders (either directors or substantial shareholders) trading their firms' shares and 0 otherwise. *Ret* is the annual returns of sample firm. *AbRet* is the difference between annual firm return and annual market return proxied by Hang Seng Index return.

			Ret		***AbRet***	
	Dummy Code	**N**	**Mean**	**Mean Difference**	**Mean**	**Mean Difference**
InsiderD	1	1372	-0.0509	0.0960**++	-0.1045	0.0143
	0	6515	-0.1469		-0.1188	
DirD	1	692	0.0335	0.1793**++	-0.0676	0.0534*
	0	7193	-0.1459		-0.1210	
SubstanD	1	1234	-0.0766	0.0634*++	-0.1216	-0.0063
	0	6651	-0.1401		-0.1153	

* 0.05 significance level for difference between subsamples (parametric test)
** 0.01 significance level for difference between subsamples (parametric test)
+ 0.05 significance level for difference between subsamples (non-parametric test)
++ 0.01 significance level for difference between subsamples (non-parametric test)

Table 3. Regression Analysis (2000-2008). *DirD* is a dummy coded 1 if the firm has directors trading their firms' shares and 0 otherwise. *SubstanD* is a dummy coded 1 if the firm has substantial shareholders trading their firms' shares and 0 otherwise. *InsiderD* is a dummy coded 1 if the firm has insiders (either directors or substantial shareholders) trading their firms' shares and 0 otherwise. *Ret* is the annual returns of sample firm. *AbRet* is the difference between annual firm return and annual market return proxied by Hang Seng Index return. *LnSize* is log of firm market capitalization. *DebtRatio* is ratio of debt to total assets.

	Ret			***AbRet***		
	Coefficient (t-statistic)			**Coefficient (t-statistic)**		
Intercept	-0.8528	-0.8498	-0.8480	-0.5509	-0.5606	-0.5639
	(-24.38)	(-24.36)	(-24.13)	(-19.47)	(-19.45)	(-20.08)
InsiderD	0.0898			0.0085		
	(3.47)**			(0.43)		
DirD		0.1596			0.0546	
		(5.36)**			(2.24)*	
SubstanD			0.0530			-0.0086
			(2.01)*			(-0.41)
LnSize	0.0744	0.0746	0.0757	0.0644	0.0644	0.0658
	(17.44)**	(17.56)**	(17.78)**	(16.73)**	(16.89)**	(17.16)**
DebtRatio	-0.1038	-0.1028	-0.1033	-0.0913	-0.0909	-0.0910
	(-2.46)*	(-2.44)*	(-2.46)*	(-2.29)*	(-2.28)*	(-2.28)*
Industry Dummies included						
Year Dummies included						
Adj-R2	0.1302	0.1318	0.1292	0.0501	0.0506	0.0501
F-statistics	91.8204	93.0888	90.9851	42.5746	39.2138	42.5650
p-value	0.0000	0.0000	0.0000	0.0000	0.0000	0.0000
N	7885	7885	7885	7885	7885	7885

* 0.05 significance level
** 0.01 significance level

However, for the abnormal return (*AbRet*) comparison, only the mean difference between *DirD* and non-*DirD* are significantly different at 0.05 level with the subsample of *DirD* earns higher abnormal return than non-*DirD*. These results suggest that firms with inside transactions earn higher return than firms without inside transactions, providing preliminary support to my hypothesis that inside transactions are beneficial to the firm's value.
(Table 2)

I further report the result of regression model (2) in

Table 3. The coefficients on the three insider trading variables, *InsiderD*, *DirD* and *SubstanD*, are positively related to *Ret* and the coefficient on *DirD* is positively related to *AbRet*. This finding provides support to the hypothesis that the presence of insider trading is beneficial to the firms. Furthermore, *LnSize* and *DebtRatio* are positively and negatively related to *Ret* and *AbRet*, respectively, suggesting that firms with larger size and lower debt are able to earn higher returns through insider trading. My results show that insider trading is an effective signal for the market to select stocks in the Hong Kong context.

CONCLUSION

Apart from the laws and economics scholars' reviews and studies, the business ethics literature questions the societal value of insider trading. Previous studies argue that insider trading imposes negative impacts on the market as insiders get profits at the expense of outsiders. The significance of this study relates to my investigation of the sun side (i.e., positive impacts) of insider trading. Insider trading continues to be a research focus as there are unresolved controversies that have implications for efficient market theory and regulatory policy. Some researchers (e.g., Moore, 1990; Werhane, 1989) argue that insider trading both in its present illegal footing and/or as a legalized market mechanism would undermine the efficient and proper functioning of a free economy.

In this study, I have responded to the above from the economic and ethical perspectives. I examine how insider trading may benefit all shareholders instead of channeling wealth to the insiders only. I explore the effects of informed trading on market reaction in Hong Kong where insider trading is allowed. One motivation of insider trading I propose is based on information asymmetry. When the firms (directors and substantial shareholders) believe that their stocks are substantially mispriced, one informal approach to provide a strong signal that the stock is mispriced is through insider trading. The market may perceive these trades as valuation correction signal. In this study, I report a result that firms with insider trading earn higher returns than firms without, and hence lend support to my hypothesis that insider trading can provide benefits to the firms. This study shows some evidence that insider trading is beneficial to the society by providing correctional signal to the market about the firm value and increasing shareholders wealth. Hong Kong is an international financial centre. My empirical finding sheds light on how this thematic topic in business management could be better addressed through more reviews or studies to be conducted for other developed economies. By extending to the perspectives of the influence of personality and demographic variables to insider trading (e.g., Terpstra, et. al., 1993), there is an enriched areas for further research, enlightening the further direction of how insider trading would be sharped in the modern business environment without compromise in terms of ethics.

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