Opportunistic Trading in Canada

Master Thesis
in
Banking and Finance

Swiss Banking Institute
University of Zurich

Supervisors:

Professor Dr. Michel Habib
Diego Ostinelli

Submitted by:

Philipp Schärli
E-Mail: Philipp.Schaerli@uzh.ch
07-726-185
Date: January 30th 2013

University of Zurich UZH

Executive Summary

This study analyses the trading behaviour of Canadian insiders of 86 firms listed in the TSX 60 index from 2006-2012. Insiders are categorized as either routine traders who trade during the same month every year or as opportunistic traders who exhibit irregular trading patterns.

Company insiders are in a privileged position: they have access to confidential information that the public does not. Undoubtedly some insiders use that information to make more profitable trades. At the turn of the century, Canadian stock markets had the reputation of widespread insider trading but few prosecutions and convictions compared to the United States. Since then, regulators have cracked down on illegal insider trading and investigations have picked up. Most studies on insider trading have focused on the United States.

Insiders trade for a variety of reasons. Due to equity compensation, insiders can have a large part of their wealth in their company. This makes personal liquidity and diversification motives a relevant factor for insiders buying or selling their shares. Insiders often receive discount plans on their own stocks. The expiry date of an option can also influence the timing of an insider's trades. The people who commit illegal insider trading in Canada are not limited to CEOs, senior management and board members. Many others obtain access to undisclosed material information. Investigations over the last decade have included lawyers in mergers and acquisitions transactions, executive secretaries, legal secretaries, accountants, printers of reports, geologists and IT system administrators.

The idea of this study is to separate insiders who trade for non-informative purposes from those who try to exploit their private information by analysing the time pattern of their trades. If an insider trades in the same months over three years, he is classified as a routine trader. Stock compensation plans can be a reason for this. Everyone else who does not trade in the same month over three years is classified as an opportunistic trader.

A pooled regression tests if opportunistic insider trading is informational for next month's stock returns model. It controls for factors that influence stock returns:

The market value of a firm, the book-to-market ratio and last month's stock returns. The insider trading signals are used as dummy variables. The portfolios follow the trades of insiders, which are public information. The holding period for stocks is one month. The Capital Asset Pricing Model is used to test if any of these strategies generate abnormal returns.

The time frame of the study is due to the availability of data in the new Canadian System for Electronic Disclosure by Insiders (SEDI), which was introduced in 2003. A comprehensive database was not available before as insider trades were published in a bulletin every week. SEDI also improved the reporting quality of trades by insiders. The trading patterns of insiders are analysed from 2003-2006 to classify them as either routine or insider traders. Their trades from 2006-2012 are then analysed.

It is found that neither opportunistic nor routine traders' signals are informative for monthly stock returns, whereas a firm's market value, the book-to-market ratio and last month's stock returns all have predictive power. By building portfolios following Canadian insiders' trades, an outsider would not have been able to earn abnormal returns. None of the trading strategies resulted in positive alphas.

But this study should not be interpreted as evidence that insiders are not profitable in their trading. It was shown that a generalized trading strategy roughly following the trades of insiders would not have been profitable. Insider trades may still be profitable for the insiders themselves depending on the holding period and the size of the trades.

Harsher regulation and prosecution may rob insider trades of informativeness. Smarter insiders conduct illegal insider trading through channels that are harder to monitor. Recent prosecutions have shown that illegal insider trading is mostly conducted not through the insider's own accounts in Canada but through nominee and sometimes offshore accounts. But trades that are not reported cannot be used by outsiders to replicate the trades of insiders.