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Brokers' activity raises flags; Study finds big increase in buying and selling after insider trades

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A study by professors at Wilfrid Laurier University found "substantial" evidence of tipping by brokerage firms using inside information on the Toronto Stock Exchange from 2004 to 2006.

Professors William McNally, Andriy Shkilko, and Brian Smith used data provided by the exchange to take a closer look at market activity by brokerage firms that acted for company insiders. Those are top directors and executives who may be privy to information that has not been disclosed to the public.

They found that brokerage firms of insiders nearly double their activity after an insider trade.

"We're concerned because our evidence suggests that some market participants, meaning the broker and some of his or her clients, are getting information ahead of the rest of the market," Smith said in an interview.

In Canada, it's illegal to provide tips or trade on the basis of undisclosed information, including insider trades.

"The passing of information regarding any client's activity is prohibited, insider or otherwise, and doing so would be a breach of our rules," a spokesperson for the Investment Industry Regulatory Organization of Canada told the Star, when asked to comment on the study.

"At IIROC, we are focused on strengthening market integrity through effective market and investment deal regulation and supervisory oversight."

The researchers are the winners of the 2012 Canadian Investment Research Award for their paper, called Do Brokers of Insiders Tip Other Clients? The paper was selected by a panel of judges from among nine submissions.

The researchers were given $10,000, an award sponsored by Hillsdale Investment Management and the Toronto CFA (Chartered Financial Analyst) Society.

Insiders are required to disclose their status to their brokerage firms which, in turn, are required to flag insider orders on the TSX trading system, according to the study.

Using a subset of TSX data obtained through IIROC, the professors studied orders and trades from October 2004 to December 2006 with the insider flag.

Since the data also includes a brokerage firm ID for each order, the researchers were able to track broker activity around insider trades.

For instance, if a president of a company bought shares and his or her brokerage handled that trade, they then tracked all the buying activity by that brokerage and compared it to the normal level of buying activity.

"We found there was a spike, not only on the day when the insider bought, but also in the half-hour when the insider bought, so we really narrowed it down," Smith said.

On the days when insiders sold shares, their brokerage firms' market share of activity almost doubled from 4.6 per cent to 8.2 per cent. Activity also doubled when insiders bought shares.

Though the study raises awareness of what was happening in markets at the time, it does not serve as direct evidence of wrongdoing, Shkilko points out.

"In other words, we don't have a broker's phone records or email records that say I'm going to tell someone else about this trading," he said. "Ours is indirect evidence, but we excluded alternative explanations to this evidence. The only explanation that we have left is that brokers often tip others when they execute insider trades."

Insider reporting regulations have changed since the mid-2000s. Insiders used to have 10 days to report their activity to regulators. Today, insiders have five days to report to regulators. The TSX recently began publishing daily summaries of insider trading activities. As well, insiders of large companies that trade on the TSX often pre-announce stock sales or purchases.

"Technology has caught up to what these professors have found. No longer would it be possible for a broker to have that information for nine days. That information now has value only for a few hours, at which point it gets publicly disseminated by the TSX," said Chris Guthrie, head of Hillsdale Investment.

This research should be part of a continuing discussion between regulators and market participants about tipping and insider trading, Guthrie said. "The issue should stay front and centre, and the pressure to raise standards should never come off."

Shkilko agreed that the window for reporting this information has narrowed, but suggests this may not solve the problem of tipping.

"Brokers used most of this information during the day, anyway," Shkilko said. "The fact that the TSX now publishes insider transaction statistics at the end of the day isn't really hurting what we found."

The professors say they may do more research in this area.

"We answered the question we wanted to answer, but now that the TSX has started publishing daily statistics on insider trading, it may be interesting to see how that changed things," Smith said. "There could be a follow-up study if we can get newer data."

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