WHEN NO LAW IS BETTER THAN A GOOD LAW

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KEYNOTE ADDRESS

The Development of Stock Exchanges

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(Prof. Hazem Daouk of Cornell University was my coauthor for all the research presented here)

Mexico had an insider trading law (1975), but had never enforced it (1998)

FINDING:

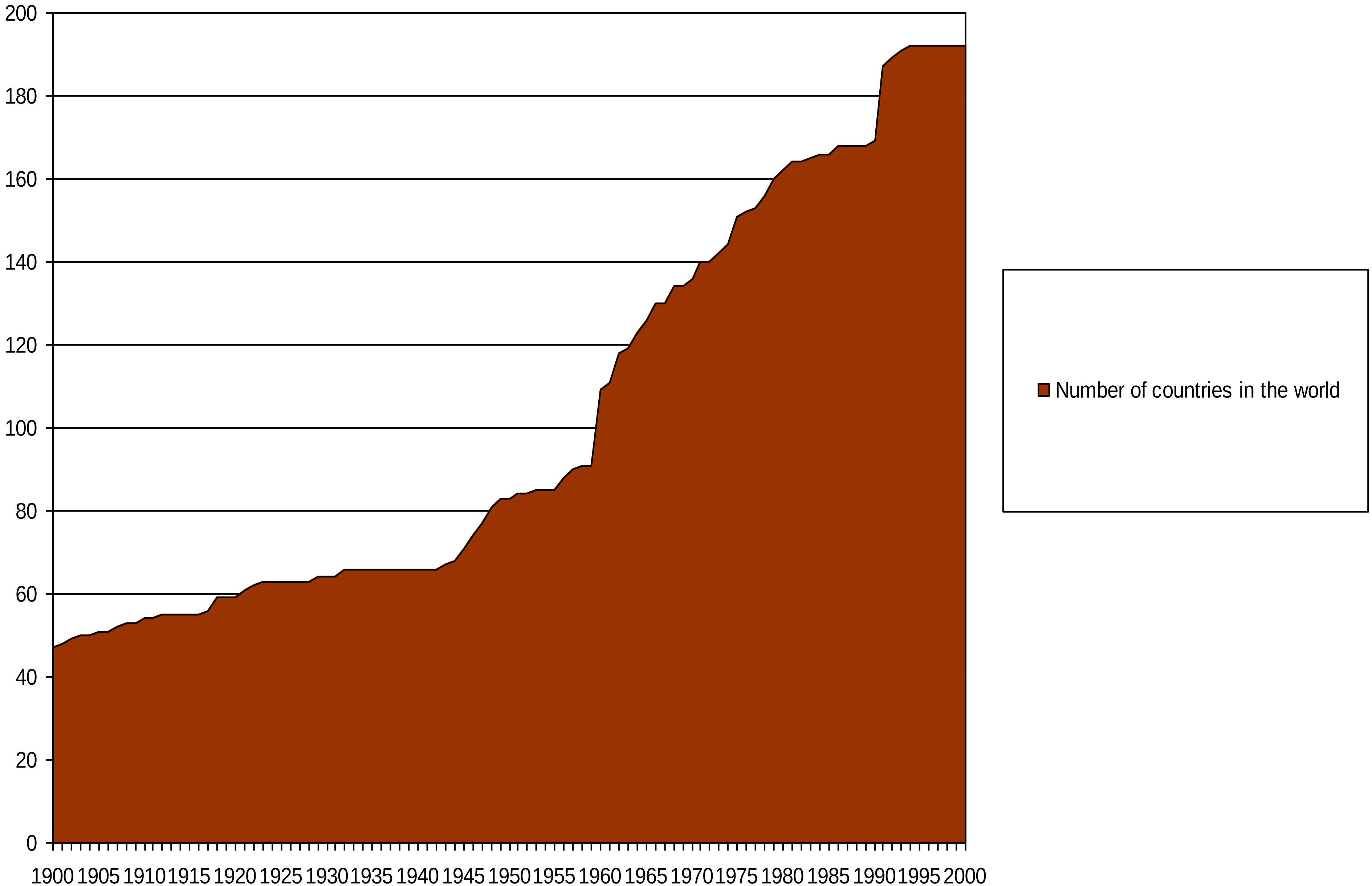
When corporations made news announcements in Mexico in the years 1994-1997, nothing happened to their share prices. There was no event.

CONCLUSION OF STUDY 1:

Any of five hypotheses could explain this. All, except rampant insider trading, were ruled out.

That was Mexico. What about the world?

Figure 1. Insider Trading Regulations in the Twentieth Century



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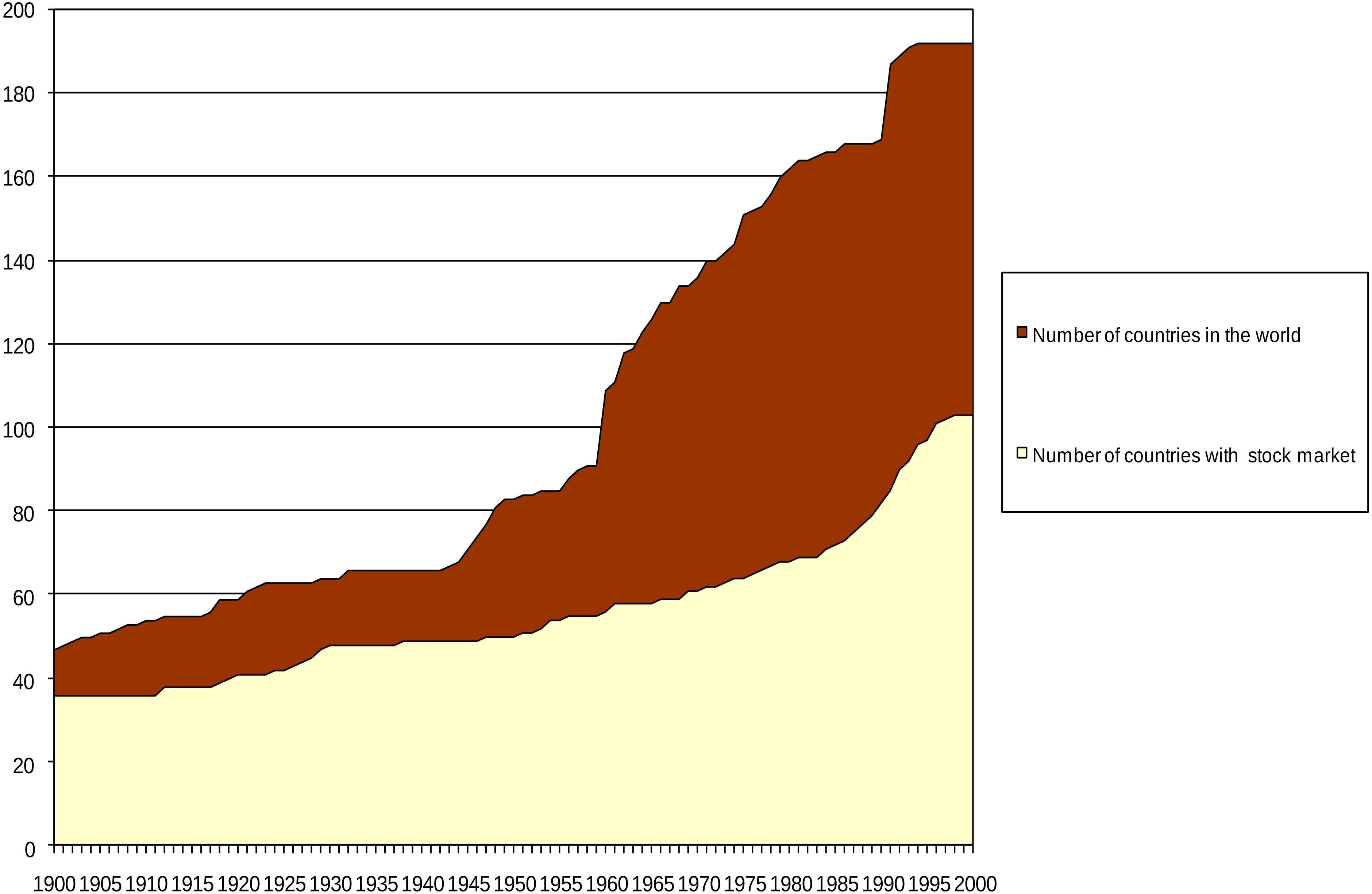

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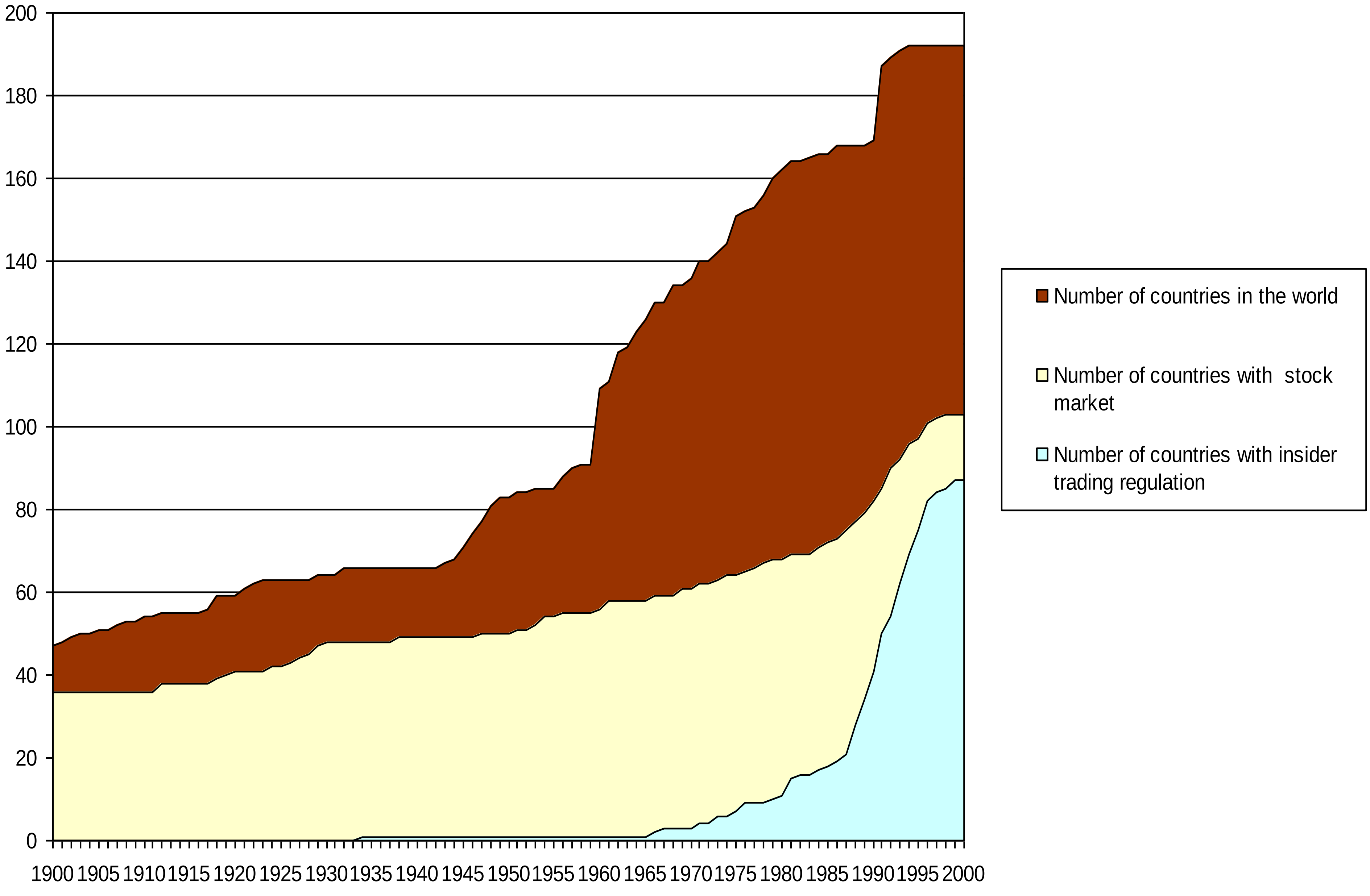

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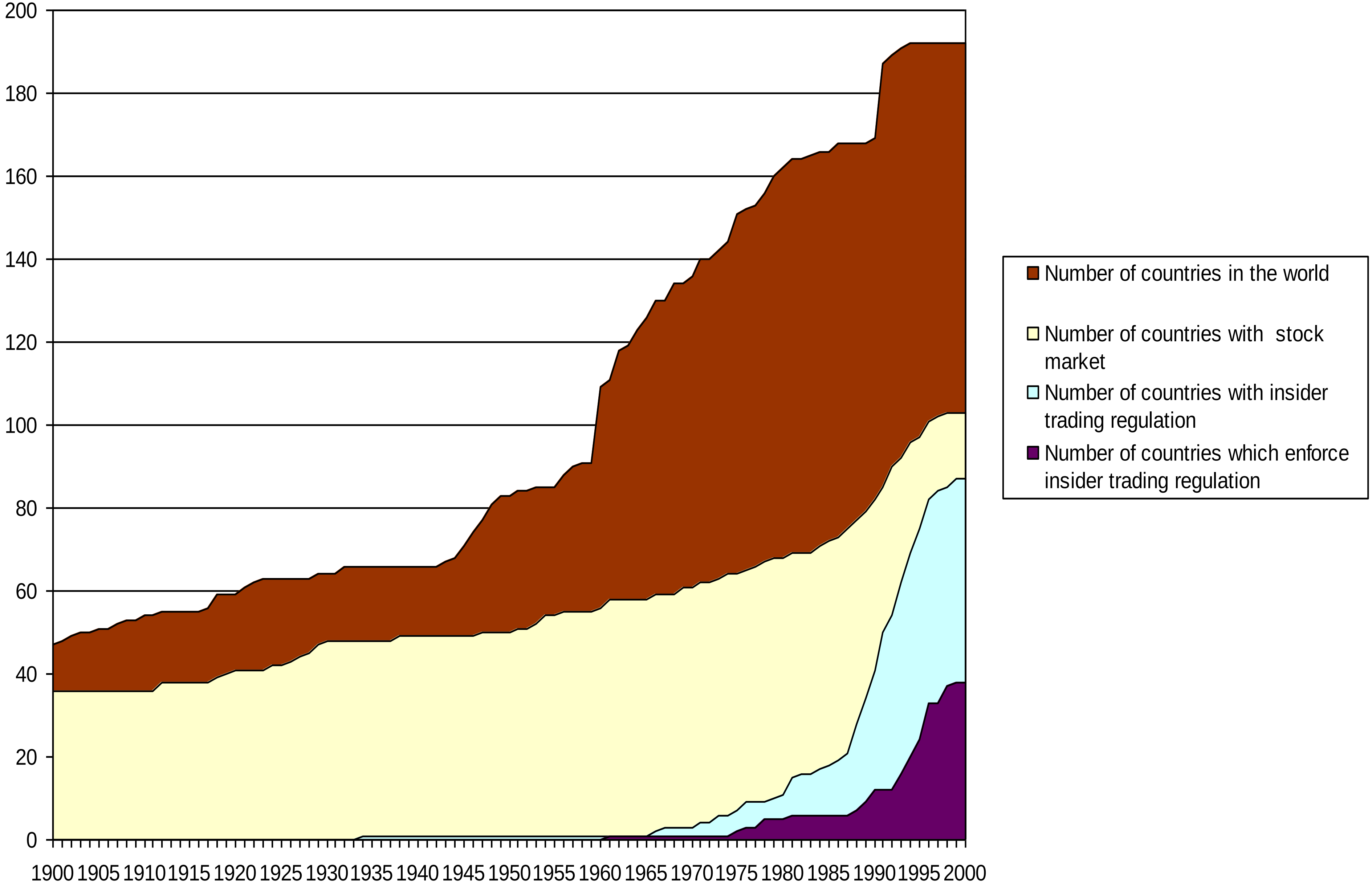

CONCLUSION OF STUDY 2:

COUNTRIES DO NOT LIKE INSIDER TRADING,

BUT THEY DO VERY LITTLE TO PREVENT IT

The World Price of Insider Trading: Effect of IT Laws on the Cost of Equity

FINANCE USES FOUR APPROACHES TO ESTIMATE COST OF EQUITY

- **Simple Descriptive Statistics**
- **Using an International Asset Pricing Model**
- **Using Dividend Yields**
- **Using Country Credit Ratings**

Conclusion of Study 3:

Whichever way you estimate cost of equity (CoE),

the enactment of IT law does not impact CoE,

the enforcement of IT law reduces CoE.

So,

IT IS NOT THE LAW, STUPID,

IT IS THE ENFORCEMENT THAT COUNTS

CAN WE CLAIM SOMETHING EVEN STRONGER AND, PERHAPS, RADICAL–

AN UNENFORCED GOOD LAW IS WORSE THAN NO LAW AT ALL?

CONCLUSION OF STUDY 4:

THE
ENACTMENT,
BUT NO ENFORCEMENT
OF IT LAW
INCREASES
COE
(ONLY FOR DEVELOPING COUNTRIES)

So,

SOMETIMES NO LAW IS BETTER THAN A GOOD LAW

This is counter-intuitive.

We expect this

NO LAW ♎ LAW – ENFO ♎ LAW+ENFO

Not this

NO LAW ♏ LAW – ENFO ♎ LAW+ENFO

WHEN IS NO LAW BETTER THAN A GOOD LAW?

TO ANSWER "WHEN," WE FIRST NEED TO ANSWER TWO QUESTIONS

1) WHY ARE LAWS INTRODUCED IN SOCIETY?

Or

1) What is a Good Law?

ANSWER TO 1):

Legal Theory Says that One Reason Why

A GOOD LAW IS INTRODUCED IS TO SOLVE A PRISONER'S DILEMMA PROBLEM

		Person 1	
		Obey Law	Do Not Obey Law
Person 2	Obey Law	U_h , U_h	U_h^+ , U_l^-
	Do Not Obey Law	U_l^- , U_h^+	U_l , U_l

2) IF ANSWER TO 1) IS AS GIVEN, WHAT HAPPENS IF THERE ARE GOOD GUYS AND BAD GUYS?

ANSWER TO 2):

NO LAW IS BETTER THAN AN UNENFORCED GOOD LAW

		Person 1	
		Obey Law	Do Not Obey Law
Person 2	Obey Law	U_h , U_h	U_h^+ , U_l^-
	Do Not Obey Law	U_l^- , U_h^+	U_l , U_l

The specific case of insider trading

LAW AND ENFORCEMENT ✡ NO ONE TRADES WITH INSIDE INFORMATION ✡ NO ADVERSE SELECTION ✡ HIGHEST IPO/SEO SELLING PRICE ✡ LOWEST COST OF EQUITY

NO LAW ✡ EVERYONE TRADES WITH INSIDE INFORMATION, BUT WITH LOW INTENSITY ✡ MEDIUM ADVERSE SELECTION ✡ MEDIUM IPO/SEO SELLING PRICE ✡ MEDIUM COST OF EQUITY

LAW, BUT NO ENFORCEMENT ✡ ONLY BAD GUYS TRADE WITH INSIDE INFORMATION, BUT WITH HIGH INTENSITY ✡ HIGHEST ADVERSE SELECTION ✡ LOWEST IPO/SEO SELLING PRICE ✡ HIGHEST COST OF EQUITY

Summary of Our Minor Research Findings

- **We formalized the conditions under which no law is better than a good law.**

ANSWER: Classic Prisoner's Dilemma+Heterogeneity

- **We checked whether insider trading laws satisfy the above conditions**

ANSWER: They sometimes do (if the conditions hold)

- **We tested whether cost of equity rises when a country passes an insider trading law but does not enforce it**

ANSWER: It does for emerging markets

But Some Major Policy Implications

- **NO LAW IS BETTER THAN A GOOD LAW IS TRUE**

ONLY FOR LAWS THAT PROHIBIT ACTIONS THAT HAVE STRONG NEGATIVE EXTERNALITY AND STRONG POSITIVE INTERNALITY

ONLY IN SOCIETIES WHERE THE LAW IS NOT RESPECTED

EXAMPLE: Capital Market Laws (Security Laws, Corporate Governance Laws) in many Emerging Markets

- **TRANSNATIONAL CORPORATIONS SHOULD AVOID TOP-DOWN IMPOSITIONS FOR SOME COUNTRIES**

EXAMPLE: IMF/World Bank/OECD/EU/…imposition of best practices

- **DANGEROUS TO ENACT "CUT AND PASTE" GOOD LAWS WITHOUT THE POLITICAL, LEGAL, CULTURAL, AND INSTITUTIONAL FRAMEWORK FOR ENFORCEMENT**

DO NOT ENACT A LAW IN SOME COUNTRIES UNLESS THE COUNTRY IS ABLE TO AND CAN ENFORCE IT !!!!!!!!!!!!