E C O N O M I C S B U L L E T I N

Disclosure of mergers without regulatory restrictions: Insider trading in pre-1914 Germany

Gerhard Kling
University of the West of England

Abstract

In the pre-World-War I period, lacking regulatory restrictions allowed 'hidden' mergers; however, some companies disclosed information voluntarily. I analyze insider gains by investigating the share price behavior prior to merger announcements. When companies hid information, stocks exhibited positive abnormal returns prior to newspaper reports that uncovered hidden transactions.

My paper was presented at the NBER conference on 'Developing and Sustaining Financial Markets'; accordingly, I thank Marc Weidenmier for his excellent comments as well as Lance Davis, Larry Neal, and Eugene White. I am also grateful for the comments I received at the annual meeting of the Economic History Society.
Citation: Kling, Gerhard, (2008) "Disclosure of mergers without regulatory restrictions: Insider trading in pre-1914 Germany." *Economics Bulletin*, Vol. 7, No. 2 pp. 1-7
Submitted: October 15, 2007. **Accepted:** January 5, 2008.
URL: http://economicsbulletin.vanderbilt.edu/2008/volume7/EB-07G10015A.pdf

1. Introduction

To observe whether companies voluntarily disclose mergers or hide information, one has to go far back in history, when neither moral pressure nor legal consequences prevented managers and principal shareholders from abusing their insider information. The pre-1914 period in Germany did not exhibit tight regulation concerning the disclosure of mergers; hence, this period is an appropriate choice for historical 'experiments'. Tilly (1982) found high merger activity in 1908; hence, I chose this year for my analysis. Acquirers were able to postpone official merger announcements, which gave them the opportunity to purchase stocks of target firms cheaper on the stock exchange than by an official public offer. Yet, companies were not able to hide their objectives perfectly, because newspapers spread rumors about imminent mergers.

Keown and Pinkerton (1981) used pre-announcement adjustments of share prices to uncover insider activities triggered by mergers in 1975-1978. Only Banerjee and Eckhard (2001) provided evidence for insider trading in a historical period, namely 1896-1903. Both studies focused on the US. Germany is due to the late introduction of rules against insider trading and its corporate governance structure an interesting case. Fohlin (2005) stressed the high level of concentration of ownership and control due to family dynasties, cross-ownership among companies, and relationship banking (bank involved in ownership and control of non-financial corporations). Separation of ownership and control was not predominant, as managers were often principal shareholders. Members of supervisory boards had a considerable stake in the company; thereby, free rider problems did not prevent effective control of the management. Majority shareholders and integration among firms through cross-shareholding and communities of interest facilitated controlling managers.

My study has a crucial empirical advantage compared to Banerjee and Eckhard (2001) in that I collected daily instead of weekly data. Morse (1984) pointed out that the lower the frequency of data the more cross-sectional units are needed to maintain a high power of event-studies. Therefore, collecting daily returns for my historical sample is a considerable improvement compared to former research.

My paper is organizing as follows. Section two addresses the legislative framework in Germany in the pre-1914 period. The method of sampling is presented followed by a discussion of my empirical findings. Finally, concluding remarks stress policy recommendations that can be derived from my results.

2. Regulatory framework

The exchange law (*Börsengesetz*) of 1896 provided the legal framework for the period from 1896 to 1914. The term insider did not exist at that time – but contemporary reports of the committee (BEK)[1] that discussed the exchange law pointed out that there was a fear of unregulated speculation that could destabilize exchanges. This fear was caused by the experiences of the crisis in 1873 (*Gruenderkrise*). An increase in speculation – among other factors – was made responsible for the pronounced decline in asset prices. Contemporaries used the term speculation or speculator in a different way compared to the recent finance literature. Every transaction motivated by an expected future increase in the market value of the respective company was seen as speculation. Noteworthy, the BEK distinguished between two forms of speculation, namely justified and unjustified speculation. A speculation was unjustified if speculators acted like gamblers and did not base their investment decision on the evaluation of the company's real economic situation.[2] Furthermore, the BEK thought that speculators were responsible for the deviation of stock prices from their justified fundamental values. This excessive over- or underestimation of fundamental values was considered as

[1] See Weber (2000) for a precise discussion of the reports provided by the Börsen Enquete Kommission (BEK).
[2] Even contemporary economists like Bachmann (1898) had problems to precisely distinguish between justified and unjustified speculation.

main source of additional risk and, hence, higher stock price volatility.[3] To reduce the influence of speculation on stock prices, the exchange law restricted forward dealings, as these financial instruments were seen as a device mostly used by speculators.[4] Since the introduction of the exchange law in 1896 and the complete cessation of option dealing in 1914, the futures market regained its former importance in terms of liquidity and trading volume not before the 1970s. The focus of the exchange law in 1896 was on forward dealings and not on prohibiting insider trading by forcing companies to disclose price-sensitive information.

3. Data

To evaluate the impact of official merger announcements and the publication of rumors about hidden mergers, I read the daily newspaper "Berliner Börsenzeitung" in 1908. The "Berliner Börsenzeitung" was the leading newspaper for investors; thus, one can regard mergers released by the "Berliner Börsenzeitung" as public information. In 1908, 101 mergers were discussed in the newspaper out of which 46 were included in my sample, as not all companies were listed on stock exchanges. Moreover, 13 firms out of 46 decided to hide an imminent merger. To obtain an impression about the strength of my data set, one can refer to Banerjee and Eckhard (2001) that collected 56 mergers out of which 19 were not disclosed. They collected weekly information about mergers and share prices.[5] In contrast, I used daily returns and determined the exact day on which the newspaper revealed mergers. In my sample, banks were responsible for 43.1% of all mergers followed by manufacturing (36.7%), the transportation industry (10.1%), and raw material production (10.1%). Besides collecting information on newspaper articles, my sample contains daily share price. To assess whether stock returns around merger announcements deviated from the normal stock price movements, I collected 50 daily share prices of every stock twelve months prior to the merger; thus, these share prices were not affected by announcements.

4. Results

Based on event study methods (see Masulis, 1980; Armitage, 1995), I derive abnormal returns for the event period that starts 15 days before the announcement and ends 15 days afterwards. As a market index did not exist in the pre-1914 period, I use a constant-mean-return model. Figure 1 plots cumulated abnormal returns of the portfolio of hidden and disclosed mergers in 1908. Stock prices of firms that hide information exhibited a remarkable increase over the whole period of 31 days by 5.60% (p-value 0.000), whereas the market values of firms that disclosed mergers increased only by 1.63% (p-value 0.027). To assess the extent of insider gains, I analyze the cumulated abnormal returns prior to announcements (t=1,2,…,15). Table 1 contains these run-ups for hidden and disclosed mergers. If the merger is officially disclosed, the cumulated abnormal return prior to the event day adds up to 0.73% (p-value 0.152) and is insignificant. On the event day, the average market value increases by 0.40% (p-value 0.032); thus, the announced merger has a strong impact on stock prices. After the disclosure, the adaptation process of stock prices is not yet completed, and the cumulated significant effect reaches 0.89% (p-value 0.091). In contrast, hiding information negatively affected small shareholders (outsiders) because a pronounced increase in stock prices by 4.79% (p-value 0.000) occurred before the merger became public information. After outsiders update their information by reading about rumors in the newspaper, further profits were

[3] If the exchange law of 1896 really influenced the observable excess volatility is still debating (see, for instance, Wetzel, 1996).

[4] See exchange law (BörsG) §§48-69. Falke (1979) pointed out that the law of the year 1896 was focused mainly on forward dealings regarding grain and flour. He also stressed the new publication requirements if a firm went public or issued additional shares.

[5] They relied on information provided by the weekly newspaper "The Commercial and Financial Chronicle".

hardly possible. Consider that the event day had nearly no impact on market values; the abnormal return was very close to zero. Moreover, a considerable part of 85.49% of the whole price impact of a merger was already reflected in the market prices before mergers were released.

5. Conclusion

Hiding information negatively affected small shareholders, as share prices before the event day reflected more than 85% of the total change in market value due to mergers. Nevertheless, the majority of the companies decided to release price-sensitive information. A possible advantage of voluntary disclosure is that companies could improve their reputation and could stay trustworthy for small shareholders. This was relevant if acquiring companies had to finance their expansion by issuing new shares. Noteworthy, issuing new shares financed 44.3% of all mergers. Despite the observed voluntary disclosure in the pre-1914 period, one could argue that small shareholders suffered when companies hid information. If a social planner wants to avoid that efficiency gains from mergers are distributed to insiders (managers and majority shareholders) and not to minority shareholders, imposing regulations that force companies to release information can be justified.

References

Armitage, S. (1995) "Event study methods an evidence on their performance" *Journal Economic Surveys* **9**, 25-52.

Bachmann, H. (1898) "Die Effektenspekulation mit besonderer Berücksichtigung der Ergebnisse der Deutschen Börsenenquete" *Zeitschrift für schweiz. Statistik* **34**, 248-288.

Banerjee, A. and E.W. Eckard (2001) "Why regulate insider trading? Evidence from the first Great Merger Wave (1896-1903)" *The American Economic Review* **91**, 1329-1349.

Falke, J. (1979) "Anlegerschutz und Unternehmenspublizität. Die Zulassung von Aktien zum Börsenhandel bis zur New Deal-Gesetzgebung in vergleichender Sicht" in *Recht und Entwicklung der Großunternehmen im 19. und frühen 20. Jahrhundert* by N. Horn and J. Kocka, Eds., Vandenhoeck & Ruprecht: Goettingen.

Fohlin, C. (2005) "The history of corporate ownership and control in Germany" in *The history of corporate governance: The rise and sometimes fall of the world's great mercantile families* by R. Morck, Eds., NBER and University of Chicago Press: Chicago.

Keown, A. J. and J. M. Pinkerton (1981) "Merger announcements and insider trading activity: An empirical investigation" *Journal of Finance* **36**, 855-869.

Masulis, R. W. (1980) "The effect of capital structure change on security prices" *Journal of Financial Economics* **8**, 139-177.

Morse, D. (1984) "An econometric analysis of the choice of daily versus monthly returns in tests of information content" *Journal of Accounting Research* **22**, 605-623.

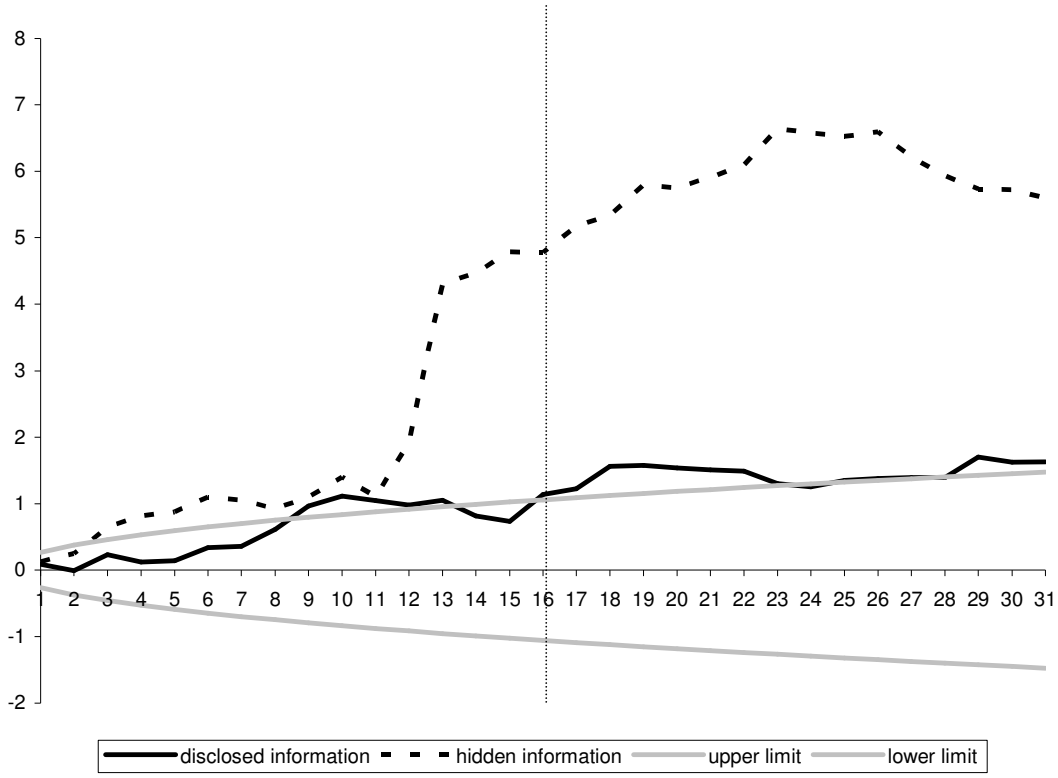
Tilly, R. (1982) "Mergers, external growth, and finance in the development of large-scale enterprise in Germany, 1880-1913" *Journal of Economic History* **42**, 629-658.

Weber, M. (2000) "Börsenwesen: Schriften und Reden 1893-1898" in *Max Weber: Boersenwesen* by K. Borchardt, Eds, Tuebingen.

Table 1. Measuring the run-ups for different types of disclosure
Note that p-values are set in parentheses.

	Revelation of information	Hidden information
Pre-announcement gains $t \in \{1,2,\ldots 15\}$	0.7335 (0.152)	4.7875 (0.000)
Gains on the event day $t=16$	0.4037 (0.032)	-0.0079 (0.952)
After-announcement gains $t \in \{16,17,\ldots 31\}$	0.8940 (0.091)	0.8128 (0.125)
Total change in market value over the 31 days	1.6275 (0.027)	5.6002 (0.000)
Pre-announcement gains in per cent of total change	45.07%	85.49%

Figure 1. Cumulated abnormal return of firms that disclose or hide information



This figure plots the aggregated cumulated abnormal return. Grey lines indicate the 95% confidence interval.