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An Empirical Study of Abnormal Stock Returns of Illegal Insider Trading - SEC Enforcement Actions for the Years 2000 to 2009

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Abstract

This dissertation investigates the abnormal returns of illegal insider trading transactions filed by the SEC insider trading enforcement actions for the years 2000 to 2009. Using a modified market model in conjunction with event study methodology, six hypotheses based on new and current theories are tested. Sample stocks are divided into positive news stocks and negative news stocks to examine their abnormal returns separately. This study supports results of previous studies that show takeover announcements generate high abnormal returns, small firms have high information asymmetry, there is large abnormal returns on positive news, and large loss avoidance on negative news. Insider trading generates higher abnormal returns for high-tech firms than for non-high-tech firms when using a Fama-French SIC code classification scheme. Abnormal returns due to insider trading generally decreased after the passage of the Sarbanes-Oxley (SOX) regulation. Illegal insider trading motivated by news on Private Investment in Public Equity (PIPEs), a specific negative news event strategy of hedge funds, show positive abnormal returns under some event windows. Overall, findings suggest that stocks with known existing insider traders are less efficient in absorbing negative news than positive news, implying that insider trading contributes to market inefficiency thus refuting the strong-form market efficiency theory. Anomalies

in the sample data support the lack of SEC enforcement for hedge funds' illegal insider trading.

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Contents

LIST OF TABLES

LIST OF FIGURES

Chapter 1

Overview of Dissertation

This dissertation is an empirical study that investigates the abnormal returns of illegal insider trading surrounding stock news announcements. The study uses sample data manually extracted from the SEC insider trading enforcement actions filed in the years 2000-2009. Analysis is separated into positive and negative news results to give insight into the types of abnormal returns earned from good news versus bad news. Some hypotheses presented and tested in the study are new and others are based on existing literature on insider trading, which I discuss throughout the literature review. Event study methodology in conjunction with a modified market model is used to estimate expected returns inside seven event window sizes. Testing is done by varying seven event window sizes using a static number of trading days in the estimation window.

This chapter is organized as follows: Statement of the problem is presented in Section 1.1, The general view in the field is discussed in Section (1.2) and the objectives of the study are presented in Section 1.3. Contributions and limitations of the research are discussed in Sections 1.4 and 1.5, respectively. Section 1.6 outlines the Organization of the Dissertation.

1.1 Statement of Problem

The problem of illegal insider trading is widespread and due to its illicit nature, the profits and loss avoidance of insider trading is impossible to measure accurately. The public has no idea of the magnitude of the unleveled playing field caused by insider trading. Insiders make exorbitant returns and avoid massive losses at the expense of the ordinary investor. Hedge funds amass great amounts of wealth since they have easy reach inside corporate boardrooms, firm management and even in Congress obtaining private information on companies for which they trade. Insiders even have knowledge of the workings of the insider trading monitoring systems of the SEC and the Self -Regulating Organizations (SROs). These sophisticated traders tailor their trades to avoid detection. The common knowledge among the insiders is that the chance of getting caught is low and the rewards are very high.

The SEC never has enough resources to combat insider trading vigorously and is overwhelmed. Preventative measures for illegal insider trading need to be taken into consideration in addition to the SEC continuing to pursue the limited number of cases per year. Quantification, even though it will never be exact, is required to pinpoint the most abusive areas of insider trading so that ideas as to how to minimize the problem can lead to actual solutions rather than just an ongoing debate.

1.2 The General View in the Field

Proponents say that insider trading is efficiency-enhancing for the market and should not be regulated. According to this view, insider trading promotes rapid price discovery and moves the stock price in the right direction. The argument further goes to say that insider trading is a victimless crime and one-size-fits-all regulation does not work. A more recent discussion of the topic is to treat corporate insider trading on positive news differently than insider trading on negative news. Insider trading on positive news can lead to overvaluation of stock prices and is considered more harmful than insider trading on negative news, which can signal overvaluation of stock prices. At the firm level, insider trading can compensate innovators in a timely fashion and self-imposed controls can be instituted at the firm level through contracts.

Opponents of insider trading claim that bid–ask spreads widen with insider trading, causing extra cost to be passed onto the ordinary investor or outsider. Insider trading is inefficient and can cause liquidity problems for the market. At the firm level, managers can delay disclosure of their benefits and profits on good news as well as bad news. Therefore, insider trading should be regulated because it is a fraud.

The view on insider trading according to the CFA Institute, the global association of chartered financial analysts, which sets the standards of excellence for the investment professional, is that:

> "Trading or inducing others to trade on material public information erodes confidence in capital markets, institutions, and investment professionals by

> supporting the idea that those with inside information and special access can take unfair advantage of the general investing public. Although trading on insider information may lead to short-term profits, in the long run, individuals and the profession as a whole suffer from such trading. These actions have caused and continue to cause investors to avoid capital markets because the markets are perceived to be ‘rigged’ in favor of the knowledgeable investor. When the investing public avoids capital markets, the markets and capital allocation become less efficient and less supportive of strong and vibrant economies” (CFA Handbook, 2014, 59).

The insider trading debate continues. Securities laws are cobbled together from the information at hand as a reaction to the latest crisis. Firms do have self-imposed controls in place to avoid litigation and to minimize reputation risk. However, insiders have many venues to hide their trades as new financial products become available. Regulators are constrained by resource allocations to investigate insider incidences and therefore focus their attention on the latest concerns, hedge funds’ use of expert networks and political intelligence firms to obtain private information.

1.3 Objectives of the Study

The objectives of this empirical study are as follows:

- To examine abnormal stock returns of insider trading in the event windows for positive and negative news events so that the most abusive areas can be pinpointed;
- To demonstrate the effects of illegal insider trading on market efficiency after positive and negative news announcements;
- To provide benchmarks for future studies on insider trading in the topics presented in this dissertation and to bring forth ideas for preventive measures.

1.4 Contributions of the Study

Overall, this dissertation advances the body of literature on the impact of illegal insider trading on firms, the capital markets, and the investing public and provides new findings. The results from this study offer benchmarks for future empirical studies on insider trading abnormal stock returns from stock news announcements in the areas of takeovers, mergers, acquisitions, technology, firm size, pre-SOX versus post-SOX and Private Investment in Public Equity (PIPEs). The study clearly separates stock news announcements into positive and negative news data and analyzes the market efficiency of absorbing that news. The results from this study also provide policy makers with new information to consider when making informed decisions on insider trading regulation. My study also contributes to the recent insider debate on asymmetric trading regimes, the separation of positive news insider trading (price increasing insider trading) and negative news trading (price decreasing insider trading) (Lambert 2006, 2010), which may be a more effective and efficient way to regulate insider trading to benefit the ordinary investor. A number of prior literature (see, for example, Lambert, 2009) have suggested that the government should be less strict in legislating on negative news trading but the results in this study contradict this view.

1.5 Limitations of My Research

The data used for this empirical study is bounded by the selection of insider trading enforcement actions that the SEC decided to file for the years 2000 through 2009.

The SEC selects only cases that the agency can handle and those cases with enough information to bring the case forward for criminal proceedings. Therefore, the data sample contains SEC selection bias. An example of selection bias from this study's data set is the underrepresentation of the number of cases brought against hedge funds because of the difficulty of establishing proof of illegal insider trading due to hedge funds' complex business models and their lack of transparency. Hedge funds are generally much less regulated compared to other financial institutions. Leadership and politics also play a role in the selection of prosecutable cases which is beyond the scope of this document.

Event study methodology, as applied in studies like this one, is somewhat limited in scope. There are seven event size windows used in this empirical study with the largest event size window being twenty days, eighteen days prior to the announcement day and one day following the announcement. Many trading positions opened by sophisticated traders such as hedge funds can be initiated months in advance, well before the beginning of the proposed event window so those earlier abnormal returns are not captured. Therefore, the abnormal returns determined in this study may be understated in the case of positive news or overstated in the case of negative news. The downside of enlarging